# Small Developer Training

## Course Curriculum

B TAP

BUSINESS TECHNICAL ASSISTANCE PROGRAM

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Community Planning & Economic Development

Business Technical Assistance Program

Credits:

*Daniel Bonilla, B-TAP Program Manager*

*Miles Mercer, Business Development Manager*

Developed by:

VARRO REAL ESTATE

*www.varrorealestate.com*

BUSINESS TECHNICAL ASSISTANCE PROGRAM
Supporting Business Growth in the City of Minneapolis

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# Section 1: Purpose of Course


Developing and investing in real estate can be an exciting and rewarding experience. It provides the opportunity to get deeply involved in your community working with area businesses, residents, and government. Real estate requires developing strong relationships with community leaders, architects and engineers, brokers, lawyers, financers, and potential tenants. It also will challenge you to partner and think creatively to solve problems, tap into your sense of good design, understand building construction, draft smart legal agreements, and analyze financials. Done well, at the end of all of this, you will have a product that is not just visible to you, but will change the landscape of the community, provide a value to residents and businesses, and deliver a decent financial return to you.

Despite the upside, real estate can be a scary and risky business. In fact, the complexity that ultimately makes real estate so fulfilling can also make it intimidating, particularly for those who are new to the industry. While any investment should be carefully considered, real estate does not need to be out of reach for the average investor. There are many opportunities for wealthy individuals and corporations to create multimillion dollar developments. Yet every day, there are average individuals who buy, build, and redevelop small residential and commercial properties that individually and collectively make a tremendous impact on their communities and provide personal fulfillment.

No book nor course can teach everything there is to know about real estate investing and development. Yet, having a basic understanding of the process, concepts, and key resources can be an invaluable way to start in real estate and help minimize initial hesitancy. The purpose of this course is to provide some initial material to help aspiring, novice, and perhaps even some experienced developers, with the knowledge and tools to build their confidence and enable greater success in their real estate ventures.

This course has four main objectives:

1. To build capacity and diversify the pool of developers in Minneapolis.
2. To educate new and inexperienced small developers in risk management and the real estate development process.
3. To build capacity and increase the likelihood of successful projects.re
4. To educate decision makers, community partners and City staff on the importance of developer capacity/experience in the evaluation of development proposals.

While many books and courses are available that help individuals gain knowledge about real estate acquisition and development, they often are targeted to large scale opportunities. In every neighborhood in Minneapolis, there are small and medium size opportunities to enhance the built environment, improve the community, and earn a profit. This guide intends to provide you, the real estate visionaries in our community, with some resources to take your next step in advancing the real estate opportunity that is right for you.

# Section 2: Introduction

### Key Concepts

- Despite its complexity, with the right skills and partnerships, it is possible to be highly successful in real estate. This course provides many basic real estate concepts to help residents and others in the Minneapolis community take those initial steps to create small and medium scale developments in their neighborhood.
- This course is organized into six general phases of development: Site Selection & Opportunity Identification; Acquisition, Due Diligence, and Entitlements; Financial Feasibility; Financing; Design & Construction; and Lease Up & Property Management
- Real estate requires a huge array of capabilities including people skills, financial acumen, negotiating ability, and technical knowledge. Understanding what is needed during each stage is important. Further, knowing your own abilities and limitations, and when to bring on external help will be critical to your success.
- There are many choices a real estate investor must make about his or her focus in real estate. These choices include Acquisition, Term, Asset, Financing, Tenant, and Geography. Where, and how narrowly, you focus in each of these areas will collectively make up your business model. Your business model will depend on your interests, capabilities, risk tolerance, and external opportunities.
- For a development to succeed, a developer must bring together four critical elements: site, tenant, money, and knowledge. You may only have one of these four elements to start but can acquire the others either directly yourself, or by establishing partnership with others. One such partnership is that of the capital partner and the operating partner.

## I. Development Process Overview

Real estate development is far from a straight path from A to B. In fact, it may often feel like a riding both a merry-go-round and a roller coaster simultaneously. Many things must be brought together at the same time to make a development succeed. Despite these multiple parallel paths, there are still various phases in the development process that must occur. The material in this course is organized into six different phases of development, which loosely occur during the development process in the order presented here.

### *A. Site Selection & Opportunity Identification*

You don't have a development if you don't have a site. Even if you begin with an idea or a tenant first, at some point early in your process you will need to identify a site for development. Initially, finding the right opportunity can be overwhelming. But knowing what to look for during your preliminary search, how to quickly filter out properties, and resources for easily gathering critical upfront information can make this part of the process much more manageable. (Section 3)

### *B. Acquisition, Due Diligence, & Entitlements*

Once you have identified a property for acquisition or development you must buy it and get all approvals necessary to build and operate it in the way you intend. Getting a property "under contract" (signed purchase agreement) is a big step, but in reality, it is when the real work begins. Due diligence, the process of investigating the property, getting financing, and making sure the property will work for you, can be fairly involved in a commercial purchase, especially if the property is going to be redeveloped. If changes are going to be made to the property, the entitlement process is a substantial and critical step. (Section 4)

### *C. Financial Feasibility*

The reality is that financial feasibility will commence from the point you begin to consider an opportunity to the moment your last lease is signed. Because an opportunity must "pencil" (i.e., make sense financially) for it to succeed, you must regularly be updating your analysis and adjusting (or getting out) as necessary. As you proceed through the development process, your revenue, cost, and other inputs will change and assumptions will be continuously refined. Your financial feasibility analysis should shift from a "back of the envelope" calculation early on to a detailed financial pro forma later in the process. (Section 5)

### *D. Financing*

Though some individuals have piles of cash in their mattress that they can use to acquire a property, build a structure, and initially operate their development, most real estate investors will need to seek partnerships with outside parties – either in the form of equity or debt. Even a great vision on the ideal site will not succeed if it can not be financed; often when developments fail, financing (or lack thereof) is the cause. Understanding the financing process and what lenders want from you can help mitigate the financing risk and make you more comfortable. (Section 6)

### *E. Design & Construction*

Design and construction is the most visible and sometimes the most exciting part of the entire development process (perhaps even more exciting than getting your first rent check!) Understanding the design process will be helpful, and having good partners can be the difference between making a development work (effective design, lower cost, necessary approvals) or not. Construction is exciting because it is visible, but it is also exciting because it marks a milestone – you have purchased the property, secured financing and all entitlements, and maybe even have a tenant lined up. However, construction can still be a scary time because you will be signing checks on a regular basis without seeing any income from tenants yet. Construction can also present unknown costs, so knowing what to look for and having good partners is critical. (Section 7)

### *F. Lease Up & Property Management*

Once the last wall is painted and the sod is laid, you have reached another major milestone. Yet, like other milestones, this is not a time to be complacent. Quality property management – keeping the property in good condition, maintaining strong relationships with your tenants, and ensuring tight accounting – will impact the long-term viability of your property.

It may be somewhat misleading to place "lease up" in the last phase given that it should occur as early as possible. The earlier you can secure a tenant or tenants, the lower your risk. Nonetheless, if your building is not full at opening, or whenever a tenant vacates, you will need to focus on leasing the empty space. Understanding how best to lease your space, including deciding whether to do this on your own or through a broker, is an important part of property management. (Section 8)

### Applying This to You!

Looking at the six phases of development, which are the areas that are most exciting to you? Which phases do you feel the most confident? Which are the phases that are most intimidating to you?

| | Score: 1=Low, 5=High | |
|---|---|---|
| **Phase** | **Exciting** | **Confidence** |
| Site Selection & Opportunity Identification | | |
| Acquisition, Due Diligence, & Entitlements | | |
| Financial Feasibility | | |
| Financing | | |
| Design & Construction | | |
| Lease Up & Property Management | | |

# II. Small Scale Development & Skills Assessment

## A. Small scale differences, risks, and rewards

While the overall process generally applies for all developments, whether a small duplex or a 40-story office tower, there are some differences in small scale versus large scale.

**Location-based** – Small developers often start because they have a connection to a specific property in their community. In fact, while big developers may have access to talent, money, and connections, the small developer advantage may be deep insight in a particular neighborhood. A small developer that knows a local market intimately, and can turn that knowledge into an opportunity that others focusing more broadly do not see.

**Start-up mentality** – Much like a cost conscience start-up who scrapes together card tables for desks and paints his own office, having a start-up mentality can allow you to make otherwise costly investments workable with a lot of sweat equity. An individual, or a small team, will often take on many of the tasks required in development to save money, such as finding and negotiating a deal and performing property upgrades.

**Financing** – Assuming you have a solid project and demonstrate competence, securing reasonable terms from a local bank for a loan should be doable. However, getting equity, if more is needed than just your own, may require a bit of digging. Larger projects will seek out capital from larger institutional investors or smaller, locally managed funds. Smaller developments may fall below the radar of these sources. In many cases, capital for small developments will need to come from a tight ring of friends, family, and other close relationships that the developer has pulled together.

**Steady growth** – A small developer is not likely to be able to retire after developing and selling off a single property. Even if the return is good, the size of the profit will be commensurate with the small project size. While small scale developers do look to make money, it is typically a steady stream of acquisitions and developments that, over time, create an impressive portfolio. It is the passion and value created in other ways that drives small developers forward.

## B. Skills needed at each stage of development

Perhaps one of the most interesting aspects of real estate is the broad set of skills that it requires to pull a development together. Even more, this means that individuals with different personalities and talents still have an opportunity to find their niche and do well in real estate. Someone who is detail-oriented may find herself focusing more on the financial modeling or legal contracts, while a person who is outgoing and enjoys working with people may lean more to developing tenant relationships.

Each phase of development has certain skills that play an important role. Many of these are described below.

Phase 1: Site Selection and Opportunity Identification

- **Intelligence gathering** - Talking to people who know an area most intimately, like neighbors, local business owners, and on-the-ground workers to understand what is happening with properties, owners, tenants, and overall trends.
- **Market analysis** –Identifying niches or needs to fill, and comparing opportunities
- **Understanding zoning** – Knowing at a high level what can and cannot be built on a site
- **Process familiarity** – Understanding what will be involved in getting from opportunity identification to project completion to anticipate opportunities and challenges
- **Visionary thinking** – Creativity; Imagining what could be and a passion for making it a reality

Phase 2: Acquisition, Due Diligence, and Entitlements

- **Contract language** – Understanding legal language and contract drafting that will ensure flexibility and buyer protection during purchase process
- **Engineering expertise** - Assessing environmental, soil, storm-water, and utility conditions and limitations
- **Building construction** – Identification of concerns with existing structure and preliminary cost estimates
- **Navigating approvals** - Familiarity with the development approval processes, including stakeholders (i.e., partners, administrators, approvers) as well as time and submittal requirements
- **Schematic Design** – Conceptualizing an “approvable” design that will be functional, cost effective, aesthetically pleasing, and timeless

Phase 3: Financial Feasibility

- **Basic math and spreadsheets** – Conducting simple calculations to estimate cash flow and returns
- **Forecasting and estimating** – Familiarity with market rents and construction and operating costs to incorporate realistic assumptions

- **Balance** – Maintaining a realistic financial model not muddied by wishful thinking, yet not so conservative that it paralyzes any action

Phase 4: Financing

- **Financial relationships** – Having or establishing strong relationships with equity partners and/or lenders who can provide funds
- **Trust and competence** – Well organized, demonstrating aptitude and an ability to get things done, to instill faith in your financial partners

Phase 5: Design & Construction

- **Design sense -** Making good decisions about materials, layouts, features, and trade-offs that influence your building's sale or rental value
- **Construction and management skills** – Hiring many skilled tradespeople and coordinating their work; keeping your project on time and on budget
- **Engineering & technical drawings** – Designing a building that is structurally sound
- **Knowledge of building code and regulations** – Ensuring construction is safe and performed appropriately

Phase 6: Lease Up & Property Management

- **Marketing and people skills** - Attracting good tenants and maintaining a good brand image for your development
- **Negotiation skills** – Negotiate financial and other lease terms to ensure a strong lease, but also a good ongoing tenant relationship
- **Conflict resolution** - Handling any tenancy issues professionally
- **Building maintenance** - Looking after major heating and cooling, plumbing, landscaping and building exterior elements

## *C. Filling gaps through personal and professional partnerships*

While it is beneficial to have a somewhat varied and adaptable skill set, to be productive in real estate does not mean you must excel in all areas. Every skill needed at every stage along the way can be obtained through partnerships and/or by hiring talent. In fact, the only notable skill some of the most successful real estate developers have is an ability to identify good talent and bring those individuals together into an effective team.

Some of the most common partners that a developer will bring on his team and the main areas they support are:

- **Real estate broker** – Market intelligence, site identification, lease up, negotiation of business terms
- **Attorney** – Assist with contracts (purchase agreements, leases) and navigating the entitlement process
- **Architect** – Site and building design; supporting the entitlement process
- **Engineers (civil, environmental, structural)** – Preliminary site inspections, site and building design, and supporting the entitlement process
- **General Contractor/Construction Project Manager** – Preliminary site and building inspections, design support, construction management
- **Market Analyst** – Independent perspective on market rates, potential for tenants and income
- **Financial Partners (equity and debt)** – Provide capital and/or loans for acquisition and construction
- **Financial Analyst** – Run financials/create pro formas to determine feasibility
- **Property Manager** – Day-to-day property operations, maintenance, tenant relationships, and lease up

Depending on your situation, you may choose to hire all, some, or none of these partners. Clearly, the more you do yourself, the less out of pocket cost you will have. Buying a small, neighborhood retail building, painting the exterior, and improving the landscaping may not require much more than your own time and vision. Larger or more complicated properties may justify a larger, sophisticated team. The important thing is to find the right balance that makes sense for you and the situation. Saving money in the short term can ultimately cost you more money and time overall from unforeseen conditions, poorly structured deals, legal challenges, inadequate design, and shoddy construction. Part of the thrill of real estate is increasing your own knowledge with each new deal. Nonetheless, be smart and partner right.

## Activity A: Small Developer Skills Inventory

| H = Have L = Will Learn O = Outsource | | | |
|---|---|---|---|
| **Phase 1: Site Selection and Opportunity Identification** | H | L | O |
| **Intelligence gathering** – Talking to people who know an area most intimately to understand what is happening with properties, owners, tenants, and overall trends | | | |
| **Market analysis** – Identifying niches or needs to fill and comparing opportunities | | | |
| **Understanding zoning** – Knowing at a high level what can and cannot be built on a site | | | |
| **Process familiarity** – Understanding what will be involved in getting from opportunity identification to project completion to anticipate opportunities and challenges | | | |
| **Visionary thinking** – Creativity; Imagining what could be and a passion for making it a reality | | | |
| NOTES: | | | |
| **Phase 2: Acquisition, Due Diligence, and Entitlements** | H | L | O |
| **Contract language** – Understanding legal language and contract drafting that will ensure flexibility and buyer protection during purchase process | | | |
| **Engineering expertise** – Assessing environmental, soil, storm-water, and utility conditions and limitations | | | |
| **Building construction** – Identification of concerns with existing structure and preliminary cost estimates | | | |
| **Navigating approvals** – Familiarity with the development approval processes, including stakeholders (i.e., partners, administrators, approvers) as well as time and submittal requirements | | | |
| **Schematic Design** – Conceptualizing an "approvable" design that will be functional, cost effective, aesthetically pleasing, and timeless | | | |
| NOTES: | | | |
| **Phase 3: Financial Feasibility** | H | L | O |
| **Basic math and spreadsheets** – Conducting simple calculations to estimate cash flow and returns | | | |
| **Forecasting and estimating** – Familiarity with market rents and construction and operating costs to incorporate realistic assumptions | | | |

| H = Have L = Will Learn O = Outsource | | | |
|---|---|---|---|
| **Phase 3: Financial Feasibility** *(continued)* | H | L | O |
| **Balance** – Maintaining a realistic financial model not muddied by wishful thinking, yet not so conservative that it paralyzes any action | | | |
| NOTES: | | | |
| **Phase 4: Financing** | H | L | O |
| **Financial relationships** – Having or establishing strong relationships with equity partners and/or lenders who can provide funds | | | |
| **Trust and competence** – Well organized, demonstrating aptitude and an ability to get things done, to instill faith in your financial partners | | | |
| NOTES: | | | |
| **Phase 5: Design & Construction** | H | L | O |
| **Design sense** – Making good decisions about materials, layouts, features, and trade-offs that influence your building's sale or rental value | | | |
| **Construction and management skills** – Hiring many skilled tradespeople and coordinating their work; keeping your project on time and on budget | | | |
| **Engineering & technical drawings** – Designing a structurally sound building | | | |
| **Knowledge of building code and regulations** – Ensuring construction is safe and performed appropriately | | | |
| NOTES: | | | |
| **Phase 6: Lease Up & Property Management** | H | L | O |
| **Marketing and people skills** – Attracting good tenants and maintaining a good brand image for your development | | | |
| **Negotiation skills** – Negotiate financial and other lease terms to ensure a strong lease, but also a good ongoing tenant relationship | | | |
| **Conflict resolution** – Handling any tenancy issues professionally | | | |
| **Building maintenance** – Looking after major heating and cooling, plumbing, landscaping and building exterior elements. | | | |
| NOTES: | | | |

# III. Determining Your Business Model

## A. Business Model Spectrums

Before you jump into the real estate world, you should consider what your strategy, or your business model, will be. The reality is that real estate investing is an extremely broad term and there are numerous different models for investing depending on the market and your abilities, interests, risk appetite, and goals. One way to determine your business model is to evaluate where you should be on each of six different real estate spectrums.

**Acquisition (Buy, Redevelop, Build)** – This spectrum differentiates an investor from a developer. An investor who only purchases fully leased buildings that do not require additional investment is interested in an existing, stable rent stream. On the opposite end is the developer who starts with a raw piece of land and does everything from design and construction, to entitlements, to lease up. At this end, the process is lengthy and the risk is high, but the financial and personal rewards can be substantial. There are also many degrees along this spectrum, including acquiring and doing a minor refresh to a full-scale redevelopment of an existing property.

**Term (Flip v. Hold)** – Some real estate investors like to buy or build properties and hold onto them in order to have a stable, long-term income producing portfolio. Others, however, seek to buy and improve a property in some way (or hope the market simply rises), and then sell off that property for a good profit. Property flips can be lucrative if done well, but they also can be high risk since they usually have less flexibility if the investment does not go well in the timeframe planned.

**Asset Type (Residential, Retail, Office, Industrial, Other)** – Asset type is not so much a spectrum, but it does provide a variety of options requiring consideration. Many real estate investors, especially smaller ones, initially focus on residential because it is familiar to them. Retail may also be attractive to newer investors since it can be done on a small scale and often as part of a mixed-use development with residential. Office and industrial may be more intimidating to real estate investors who do not have familiarity with those asset classes, and investments tend to be larger in scale, but smaller, rewarding opportunities do exist.

**Financing** – Unless you have a substantial amount of money saved up, where you are on the financing spectrum may not be entirely up to you. Nonetheless, it is still a decision that must be considered. If you do have enough money to finance an acquisition or development on your own, you may choose to do so without outside equity or debt. This gives you full control, requires less coordination, and can enable you to move more quickly. However, if you do not have enough of your own money or want to limit your exposure, you may choose to pull in other investors or debt. Because it gives you leverage, taking on debt can provide an overall better return. However, debt also will increase your risk in other ways – if you can't cover debt service you can lose your entire investment (or more if you have a personal guarantee.)

**Tenant** – Another spectrum to consider is the tenant spectrum, specifically how far along with a tenant do you want to be before you proceed. Most developers find a property that they think will be attractive to tenants, get it under control (i.e., sign a purchase agreement) then work to get commitments from enough tenants to fill a minimum amount of the space to get them to feel secure. However, not all developments work this way. Some developers will build "on spec," meaning they are willing to fully buy and build a property without any firm commitments. If they expect the market to be strong and they want to move quickly, this can pay off. On the other hand, if their predictions are incorrect, they can be stuck with a beautiful, expensive, and empty building. The other end of this spectrum is to develop a strong relationship with a tenant from the beginning and only pursue a development opportunity with that tenant's requirements in mind. This route is the least risky, but likely will provide the lowest return since your tenant partner will expect to pay you less because they are mitigating much of your risk.

Your combined position on each of these individual spectrums collectively makes up your business model. For example, perhaps you want to redevelop under-occupied office buildings for a short-term hold using debt financing. Alternatively, maybe you want to fully develop new multi-family residential using no debt and hold them for the long term. Some developers consider themselves to be "opportunistic" and remain flexible, investing in anything they determine to be a good opportunity. While this does work for some people, early on it may be beneficial to keep a narrower scope in order to strengthen your knowledge, relationships, and expertise through a single, repeatable business model.

**Geography** – One last area that should be considered as part of your real estate business model is geography. While this is not exactly a spectrum, there are trade-offs to be made when determining where you want to focus. You may choose to invest in an established neighborhood where demand is good, but prices are also high. Alternatively, you may want to invest in a neighborhood that has more economic challenges. Here the risk is higher because demand may be low and not arrive as quickly as you anticipate. Yet the reward can be good financially if you get into an up-and-coming neighborhood just ahead of the rush, and it can be personally fulfilling if your own investment helps to improve that neighborhood. In choosing your geographic focus, you also will likely want to focus on an area that you know. Because real estate is so local and so much of it is about location, it will ultimately be important to have deep knowledge of what is happening with and around your development. Also, since you will be on site frequently, it makes sense to invest in an area that doesn't require a lot of burdensome travel for you.

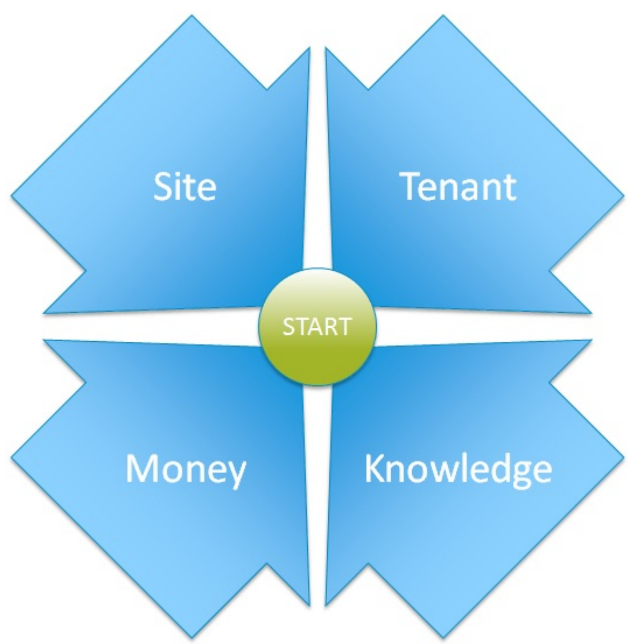
### Applying This to You!

Put together your business model. Where do you see yourself focusing in each of the six real estate business model "spectrums"?

## B. *Four Elements Needed for Success*

A successful development depends on four elements: A site, tenant(s), money, and knowledge. Odds are that you do not have all four of those things from the beginning – if you do, you are one fortunate developer. Your goal, over the course of the development, will be to obtain and bring together each of these four elements. Your Day 1 goal is to start with at least one of the four.

**Site** - Perhaps you own or could acquire a site that you know will be a great location for a particular use. If it truly is a great location, or at least great for a certain type of tenant, you have your first element. You will then need to go out and find that tenant, get money to acquire and develop the site, and get (or hire) the knowledge to get through the process.




**Tenant** – If you don't have a site in mind, only have a little money, and are not that knowledgeable in real estate, but you have a relationship with a tenant who is willing to work with you, you have your first element. Perhaps you have a friend who owns a business. She wants to lease some industrial space but can't find what she is looking for in the market and doesn't want to deal with developing and owning real estate herself. This is an opportunity for you to find her a good site, secure financing, and bring together the knowledge to develop it to her business requirements…in return for a decent lease income, of course.

**Money** – If you have money to invest in a property but do not have the knowledge, a site, or a tenant in mind, you still are at a good point. Many development deals fall apart because the developer is unable to secure financing. If this is not an issue, you will be in a strong position to reach an agreement with a seller because you can move quickly and there is less risk for the seller that you will not be able to close. If you are in this situation, you can either patiently look for a good site and/or tenant on your own. Alternatively, you could look to be the equity partner (a highly sought after role) with someone who has a site, a tenant, or the knowledge to move it all forward.

**Knowledge** – If you don't have a site, a tenant, or money, you can still lead a successful real estate development by relying on your knowledge. Some of the most successful developers don't initially have anything but their knowledge. However, because they know how to pull all the complexities together, how to manage through the process, how to analyze a deal, have at least a basic understanding of construction, and, importantly, how to build relationships to find opportunities, tenants, and financing, they are able to do deal after deal. Even if you start off not knowing anything about real estate, but you can "herd cats" and build strong relationships, you have a place to start. In fact, this element is perhaps the most beneficial because it will produce not just one opportunity, but can lead to an ongoing pipeline of developments.

> *"The journey of 1,000 miles begins with a single step."*
>
> *- Lao Tzu*

As stated, a successful development ultimately depends on all four of these elements. While you may only begin with one, you will need to acquire all four; the earlier you pull all four together the lower the risk and the better likelihood of success. The good news is these build on one another. If you have a good site or a strong tenant, it will be easier to secure financing. If you have a knowledgeable team you will quickly be able to assess a site and demonstrate confidence to a tenant. If you have two or three of the elements, it gets easier to fill in the missing pieces.

Finally, access to all four of these elements does not mean you must possess them yourself. You may not need to own the site, have the tenant relationship, know everything about the development process, and have the money. The key to effective development is understanding your own abilities, and then either acquiring any missing ones yourself, or partnering with others who have them.

## Applying This to You!

How would you rate yourself (1-10 scale) on the four critical elements a developer needs to succeed? Which one is your starting point? How can you improve your scores in areas where you fall below a 5?

| Element | Score | Low (1) | Medium | High (10) |
|---|---|---|---|---|
| Site | | Have not started looking at properties | Good local knowledge and identified some interesting opportunities | Own the perfect site |
| Tenant | | No existing relationships with potential tenants | Some relationships with potential tenants and have expressed interest in partnering | A firm commitment from a high credit tenant (or tenants) for the entire development |
| Money | | No money, no financing relationships | Some cash on hand and have relationships with equity partners and/or lenders | Cash on hand to fully finance the development |
| Knowledge | | No experience, and new to real estate development | Completed 1-2 projects and have some good relationships with key real estate partners | Completed multiple projects and have relationships with potential experts in the industry |

## *C. Establishing Your Role – Capital Partner v Operating Partner, etc.*

While it is clear that a developer must ultimately be able to access the four elements of site, tenant, money, and knowledge, each developer will differ slightly in which of these elements he or she is strongest or wants to focus. In particular, someone who has access to capital (i.e., money) who wants to invest in real estate, often may not have the ability, time, or interest to pull together all of the other elements of the development. Therefore, it is common in real estate for a *capital partner* (who has the money) to connect with an *operating partner* (who pulls everything together) to make the deal happen. The level of involvement by the capital partner can vary greatly from virtually no involvement (i.e., "silent equity") to an active partner who reviews and approves all major and many minor decisions. If a capital partner is silent, they will typically have a trusted relationship with the operating partner who has a proven record of accomplishment. The capital partner will invest the capital upfront and then earn an agreed upon return on that capital (after debt is paid but before the operating partner is paid.) The operating partner will serve as the day to day operator of the deal, bringing together knowledge, relationships, time, and attention to make the development happen. The operating partner may have his own money in the deal as well, but not always. The operating partner will earn her money by receiving a development fee, typically a small percentage (e.g., 3-5%) of the overall development cost, and often by receiving a return on the equity after the equity partners receive a certain minimum return.

## *D. Starting Small with Lower Risk – Owner Occupied and Stable Properties*

If you are reluctant to jump head first into development, you can still take small steps to increase your knowledge and give you experience and confidence. If you are new to real estate, perhaps developing a 20-story office tower is not realistic. Instead, find an opportunity that is manageable, but expands your capabilities in one or two areas. We must walk, before we can run. Secure financing from a single source before attempting to pull together a complicated financing stack from several debt and equity partners. It is helpful to understand firsthand what attracts tenants to a space before attempting to design a 50-unit residential building. Often developers begin their journey in real estate as an extension of their own home, at a small scale, and/or with stable properties.

One of the best ways to dip your toe into real estate is as an owner occupier. By buying a duplex and living in one unit and renting the other, you can begin investing without having to spend much more than you would on your own home. Starting with a small, duplex or triplex also enables you to use traditional financing options with affordable terms. Finally, starting small like this will give you familiarity with what it takes to manage a tenant and maintain a rental property.

New development can be exciting and financially rewarding, but starting with a stable property or one that requires little to no additional work can still provide good income and plenty of learning opportunities. Owning a stable property will give you exposure to day to day management and cost to operate, help you build tenant relationships, and provide access to knowledge of what is happening in the community. Further, even stable properties may have opportunities for improvement through smart capital investments, better management, and other creative way to add value.

Even if you are not yet ready to purchase your first investment property, there are still things you can be doing to prepare for a smart investment in the future. A lot of good information is available online today, and you should use that to build your knowledge base. However, online and book knowledge will only get you so far. Nothing quite compares to getting out and exploring on your own. Walk and drive around to understand how your city and neighborhood works. What is successful? What is not? What could improve your neighborhood. Most importantly, talk to people –building owners, tenants, residents, neighbors, investors, lenders, builders, brokers, attorneys, contractors, architects, city staff, mail carriers, bus drivers, etc. Each conversation will provide a clue or piece of the puzzle to help you intimately understand the complex workings of your community, and lead the way to your first undertaking – and you will likely build many great relationships along the way.

## Activity B: Model Participant Activity

# My Small Development Business Concept

**Instructions:** Circle your primary approach and note any specific ways you intend to modify/enhance the approach.

### 1. What is my primary property acquisition and disposition strategy?

| | | |
|---|---|---|
| *Buy Existing Buildings* | *Build New Buildings* | *Buy Under Valued and Renovate* |

Notes:

### 2. What is my primary building ownership and portfolio approach?

| | | |
|---|---|---|
| *Projects to sell immediately (Build/Fix and Flip)* | Projects to stabilize, hold for a while, then sell | *Projects to rent for long term cash flow* |

Notes:

### 3. What will be the primary function of the buildings?

| | | | |
|---|---|---|---|
| *Residential* | *Commercial (Retail or Office)* | *Mixed-Use* | *Industrial or Other* |

Notes:

### 4. What level of tenant commitment will I require before purchasing and construction?

| | | |
|---|---|---|
| *Commitment for 100% of space (Build to suit)* | *Commitment from anchor tenant(s) or set % of space* | *No commitment needed (Spec Development)* |

Notes:

### 5. How will I start out financing projects?

- *With my own capital via mortgages/loans with low down payments*
- *With my own capital acting as an investor (25% + down payment) with mortgages/loans*
- *With friends and family investors to provide equity for small/medium mortgages/loans*
- *With an equity partner to provide capital for a commercial grade loan*

Notes / Other Methods:

### 6. In what area of the city and specific neighborhood/district will I concentrate my work?

# Section 3: Site Selection & Opportunity Identification

## Key Concepts

- Many factors affect the viability of a real estate investment, which makes selecting the right investment both challenging and fascinating. These factors should be understood early in the site selection process to filter out poor investments and hone in on better opportunities.
- When selecting a property, an investor should understand how each factor may impact the investment, namely, will each help drive revenue and keep costs manageable, or will they hinder income, increase cost, and add risk.
- While there are many factors to consider when selecting a site, several important ones to consider include basic site specifications (e.g., size, ownership, age), zoning, price, market potential, tenants, property conditions (e.g., environmental, soils), and availability.
- More detailed property information will still require investigation by external resources, but a great deal of information needed for preliminary site selection is readily available online. Hennepin County, the City of Minneapolis, and several listing services provide extensive information through various websites.

## I. What to Consider When Selecting a Site

Part of what makes investing in real estate so fascinating are the wide array of factors that impact the viability of a successful project. Of course, just as they can make a project interesting, they also can create challenges that must be thoroughly considered. When evaluating a site, an investor must consider how factors of that site may help or hinder their ability to earn revenue (i.e., get and keep good tenants at a good rate) and manage costs (i.e., construction, ongoing management, and maintenance.) We detail some of the most important factors to consider below, though each site is different and may have unique circumstances that must be considered – which, again, is what makes real estate so interesting!

### *A. Basic Specifications*

Perhaps obvious, but when considering a property for acquisition there are some basic specifications that should be noted to understand the nature of the property.

Remember!

*1 acre = 43,560 square feet*

**Size** - To start, the property size is critical as it is going to impact both the amount of revenue that can be generated, the purchase price, construction costs, and operating costs. Land size is typically reported in acres or square feet (SF). It is also important to note if any portion of the property is unbuildable. For example, a 2-acre property with wetlands on half of the property would only be considered to have one acre of buildable area. Easements and other restrictions may also make a portion of a property unbuildable. You should also note the lot dimensions and shape; an irregular shaped lot may be more challenging to develop in an efficient manner.

For building size, it is important to note the gross, rentable, and usable square footage.

- **Gross** – Total size of the building on all floors from outside walls
- **Rentable** – Space for which you can actually charge rent. This typically is gross square feet minus vertical penetrations such as stairwells and elevators. Rentable square feet does include common space that all tenants share and are charged back on a pro rata basis
- **Usable** – The space tenants exclusively use themselves (Rentable SF less common space)

Tenants will want the most efficient space possible – they don't want to pay for space they are not using. A certain amount of common space in office buildings and some other buildings is acceptable (e.g., 15%), especially if that space is used for amenities that the tenants would value such as a fitness center, meeting space, or a cafeteria. However, too much space will make spaces harder to lease or require lower rates to make up for the inefficiency. Similarly, rentable square feet should not be too much lower than gross square feet because you are then just paying for space that does not produce revenue. In residential buildings, common space is not considered part of a tenant's square footage; nonetheless, you still will want to be sure that the building is efficient.

Remember!

*The **Building Efficiency** is the*
*ratio of Usable Space to Rentable Space*
*(aka Common Area Factor, R/U Factor, or Load Factor)*

**Ownership** – Not only is ownership important to know simply as a data point, but it can be extremely informative to understand appetite for sale and motive. Is the owner a company that has recently been divesting of assets and therefore may be willing to sell? Is the owner also the occupant who might be nearing retirement and wanting to close his business and sell his building? Perhaps the property is owned by a bank or the city through foreclosure and they are eager to dispose of the property. Alternatively, if you discover that the land is owned by the railroad or a government institution that rarely has an interest in selling, you may save yourself a lot of trouble. Further, if the current owner has a reputation (good or bad), this information can help you understand how difficult it may be to work through the purchase process or if there is a risk of deffered maintenance or poor management.

**Age** - If structures are built on the property it is important to note the age of those buildings and the age of any additional construction or upgrades to the property. While an older building may offer unique character that cannot be replicated in new construction, it also may pose additional challenges (i.e., cost) during construction. Buildings built before about 1980 may have lead paint and/or asbestos that can add cost to maintain or mitigate, even if the building is being demolished. Buildings over a certain age or within a special district may be historically designated. Such a designation usually means that the amount and type of renovation that can be conducted to the building will be limited. However, in some cases historical designation can also mean that government incentives are available to assist in the redevelopment.

**History/Previous Use** – In addition to building age and ownership, it can be helpful to know more about the overall history of the building. If the property was once used as dry cleaner or for paint production, there may be environmental concerns. (This should come out in your environmental Phase I review, but it helps to find out what you can even before getting that far.) Knowing how long ago the current owner purchased the property and for how much can also inform what her motive and expectations may be for selling.

**Parking** – Because parking is such an important component of any development, can consume a large amount of land area, and is tightly controlled by municipalities, it is important to note early on the amount of parking that is available. Ample parking, particularly in high density areas, can be a valuable amenity. Alternatively, lack of parking without adequate access by alternative modes of transportation can severely limit the success of a development.

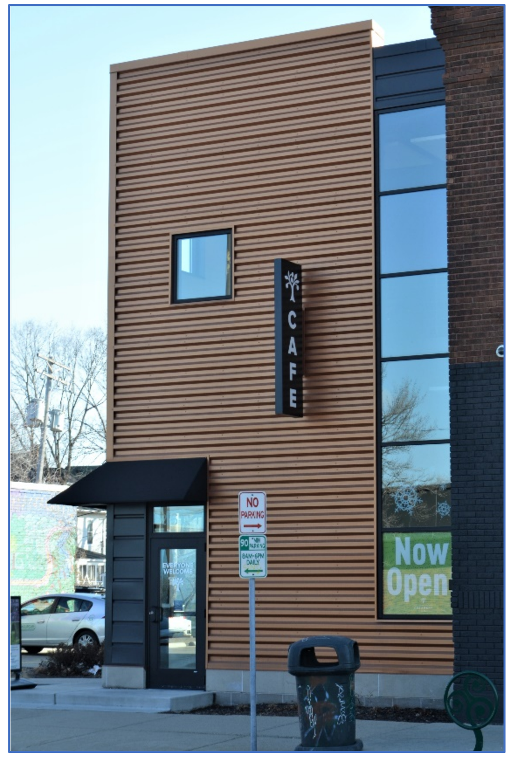
**Building Specs** – There are numerous pieces of information about existing buildings that should be gathered in early stages of identifying a site. These include number of levels, number and location of elevators, number of docks, ceiling heights (aka clear height), and mechanical systems.

## Applying This to You!

If you own a property or are considering purchasing a property, note the basic specifications of this site. When assessing these aspects of the property, will they help or hinder your ability to earn a profit?

## B. Zoning

One of the most important factors to investigate when looking for a good site, particularly for new development, is the zoning specific to that property. To start, each property will be zoned to allow particular uses, either expressly or conditionally, by the local municipality, and other uses will be prohibited. Zoning typically is labeled as residential, commercial, office, industrial, or something similar. You may want to build a small commercial building to house a restaurant on a property, but if it is zoned for residential, that might not be allowed. Municipalities will often have subcategories within each use, such R1, R2, R3 to classify uses further based on density, intensity, etc. Some cities, including Minneapolis, have overlay districts that further expand or restrict uses for particular areas or purposes.




In addition to use, zoning code details a great deal more about how buildings can be constructed on a particular site. Restrictions will often include things such as height limits, property setbacks, and floor-to-area ratios (FAR, the ratio of building floor area to property size.) These are critical to understanding whether your desired building can legally be built. Often a developer will seek density (e.g., height, limited setbacks) to provide enough income to make a development financially feasible, but may be limited by zoning code. For this reason, it is important to determine early in your site selection process if zoning will support your desired development.

If a desired use or design does not explicitly meet zoning code for a property, this does not necessarily mean you can't proceed with your development. Variances for things like height limit and setbacks can be obtained, but they require following an in-depth process with the municipality to explain why a variance is necessary and to garner support from decision makers and influencers (e.g., city council, planning commission, planners, neighbors.) Further, variances are not a given; there is a risk that you go through the process and the request is still denied. Getting a property rezoned is also possible, but also requires a lengthy process and is more challenging to get approval than obtaining a variance.

**CITY OF MINNEAPOLIS PRIMARY ZONING DISTRICTS**

*Source: http://www.minneapolismn.gov/zoningmaps/zoning_zoning-district-descriptions (1/8/17)*

**Residence Districts**

| | |
|---|---|
| R1 | Single-family District (low density) |
| R1A | Single-family District (low density) |
| R2 | Two-family District (low density) |
| R2B | Two-family District (low density) |
| R3 | Multiple-family District (medium density) |
| R4 | Multiple-family District (medium density) |
| R5 | Multiple-family District (high density) |
| R6 | Multiple-family District (high density) |

**Office Residence Districts**

| | |
|---|---|
| OR1 | Neighborhood Office Residence District |
| OR2 | High Density Office Residence District |
| OR3 | Institutional Office Residence District |

**Commercial Districts**

| | |
|---|---|
| C1 | Neighborhood Commercial District |
| C2 | Neighborhood Corridor Commercial District |
| C3A | Community Activity Center District |
| C3S | Community Shopping Center District |
| C4 | General Commercial District |

**Downtown Districts**

| | |
|---|---|
| B4 | Downtown Business District |
| B4S | Downtown Service District |
| B4C | Downtown Commercial District |

**Industrial Districts**

| | |
|---|---|
| I1 | Light Industrial District |
| I2 | Medium Industrial District |
| I3 | General Industrial District |

**Overlay Zoning Districts**

| | |
|---|---|
| PO | Pedestrian Oriented Overlay District |
| LH | Linden Hills Overlay District |
| IL | Industrial Living Overlay District |
| TP | Transitional Parking Overlay District |
| SH | Shoreland Overlay District |
| FP | Floodplain Overlay District |
| MR | Mississippi River Critical Area Overlay District |
| DP | Downtown Parking Overlay District |
| B4H | Downtown Housing Overlay District |
| DH | Downtown Height Overlay District |
| NM | Nicollet Mall Overlay District |
| HA | Harmon Area Overlay District |
| NP | North Phillips Overlay District |
| AP | Airport Overlay District |
| UA | University Area Overlay District |
| WB | West Broadway Overlay District |

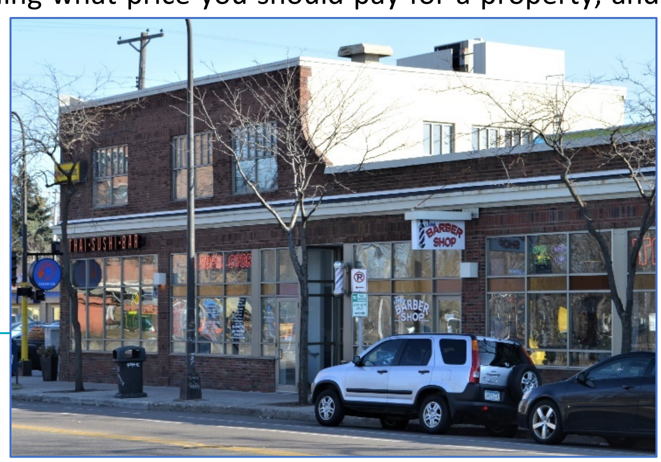
## *C. Price*

When starting out, real estate developers will often spend a lot of energy on what sale price they can get for a development once it has been built or improved, but less so on their upfront purchase. However, there is a thought in real estate that a bad investment does not come from selling too low – it comes from buying too high. When investing in real estate, an investor must seriously consider what purchase price makes sense for that specific investment. Investors should consider purchase price from three perspectives: market, investment, and personal capability.

Looking at the market by doing a sales comparison, is important to understand if a purchase price is in line with other recent sales for similar properties in the market. The process involves finding recently sold properties that are like your target property and adjusting the price, up or down, based on any differences. Because no two properties are exactly the same, nor can all differences be fully accounted for, the comparison approach is not a perfect science.

A sales comparison provides important data points when evaluating a property, but should be used cautiously. In fact, market price should be used more to understand potential sale price and lender expectations, and less on whether the investment makes sense. You may have an opportunity to purchase a property for less than what an estimated market price may be, but if the investment still does not make sense for you financially, it is still a bad price. If you are hoping to buy a property for "below market" without any indication a seller is willing to sell at such a price, you may have unrealistic expectations. However, if a seller is asking a price that is well "above market," it might be reasonable to assume a good chance the price will eventually come down (unless, of course, the seller doesn't want to admit the reality of the market.) Finally, a lender will generally be unwilling to lend money to purchase a property for more than it is worth based on the market; even if you think you can make an investment work by paying "above market," you may have trouble getting a loan to buy the property.

The second approach to determining what price you should pay for a property, and really the one that is most important, is the investment approach. This approach answers the question, "what is the maximum price I should pay for this property while still earning the return I am



seeking?" To answer this question, you must look at all other costs (both upfront and ongoing) and your expected revenue. We explain this as part of financial analysis in more detail in Chapter 5: Introduction to Financial Feasibility. By backing into a price you are willing to pay based on realistic financial inputs, assumptions, and investment criteria, ensures you have structure, consistency, and logic behind a complex, and sometimes emotional, decision. Obviously, if you can purchase a property for something below your maximum price, that is even better!

A third consideration, beyond the market and investment approach, when evaluating what you can pay for a property is your own ability. If a property is worth $500,000, but you only have $400,000, you will be limited in what you can offer. What you can pay includes both the equity (yours and your partner's) and whatever debt you can obtain. (Note: Your equity partners and your lenders(s) will use both the market and investment approach themselves to determine what they are willing to put into the investment.) If a property is worth more than you can pay, it is likely that the seller will hold out for another buyer, though that is not always the case.

## *D. Market Potential*

Simply because a site is zoned for a particular use does not mean that it will necessarily be successful supporting that use. For a development to be successful, it must be a good site for potential tenants – hence the old adage, "location, location, location!" Retail sites may be the most sensitive to the right location. Retail tenants will want a location that is easy for their customers to see and reach. A customer will choose to shop at a competing location if he feels that site is easier to access, even if that is a subconscious decision. First, retailers will want to be located close to a strong population base and their target demographic. Retailers will also look for sites with a lot of traffic – often at least 10,000 vehicles per day for smaller retailers and 50,000 or more vehicles per day for large national chains. Usually retailers focus on vehicle traffic, but in rare cases such as on university campuses or the downtown skyway system, the focus can be pedestrian traffic. Retailers also want to ensure people, whether driving, walking, etc., can easily access the locations; this means being on the proper side of the road (right in/right out) during rush hour traffic, signaled turns into the lot, and convenient parking. Retailers will also want good visibility, both for signage and the front door entrance. The storefront is one of the most important branding opportunities they have.

While other tenants may not be quite as sensitive to location as retailers, market potential for residential, office, industrial, and other uses is still critically important. Residential locations will generally do better near employment hubs, good schools, strong transportation (roads or mass transit), and amenities (natural and commercial); and will struggle more if adjacent to noxious uses (e.g., industrial areas, blight, railroad tracks) and areas with high crime. Strong office locations tend to be similar to residential – locations that will be attractive for people to work such as those with desirable amenities and good transportation. Industrial tenants will seek locations that minimize operating costs, such as near suppliers or customers, and will want to ensure stable operations.

While needs of tenants may change over time, the evolution of neighborhoods and regions are more likely to drive changes in a location's market potential. The expansion of the suburbs in the second half of the twentieth century and the more recent shift back to urban cores are good examples of trends that impact marketability. The addition of a light rail line or a freeway exit can also change market potential. On a smaller scale, simply the opening of a successful restaurant in a neighborhood can increase market potential for nearby properties.

## *E. Existing Tenants*

If you are developing a property from the ground up, or buying a vacant property, you do not need to worry about existing tenants. However, if you are considering purchasing a property with existing tenants in place, you should fully understand the tenant situation. To start, you should understand the basic terms of the leases in place, including how much they are paying and how much more time is left on the lease. In particular, a buyer should understand if rents are above or below market (i.e., is income likely to decrease or increase?) and if leases are expiring soon. Ultimately, all leases should be fully reviewed to understand all terms, including options to renew or terminate, who is responsible for property management, and which party pays for operating expenses and repairs. Beyond the terms of the lease agreement, you will want to understand background on the tenants as well to understand how stable they are. Are they a financially sound business who has been operating for many years, or are they a fledgling tenant that might be struggling to stay in business? Even if financially stable, how likely is the business to continue to operate in that location? Might they be outgrowing their space or looking to move to a different location at lease expiration? Finally, while having tenants in place can be a good thing since they provide immediate income, if you are looking to redevelop a property, existing tenants with long-term leases in place can be a hurdle, requiring you to either wait out the leases (risking market timing) or buy tenants out of their leases.

## *F. Property Conditions*

Some sites may be great locations to attract tenants and produce revenue, but may require extensive construction to deal with poor site conditions. Sites with poor soils may need to have significant work done beneath the surface of both the building and parking lot to support structures and ensure the ground does not sink. Properties that are environmentally contaminated may also require corrective measures such as soil replacement, capping, and venting before development can occur. Existing buildings may also have issues that would require significant cost to correct such as failing structural and mechanical systems, asbestos, or mold. While these building and site conditions should be fully uncovered during due diligence, you can do your own investigating during preliminary site selection by looking for potential issues (or bringing a knowledgeable friend) during building tours, understanding the history of the site, and learning if adjacent properties had environmental or soil issues.

### *G. Availability*

While property availability may seem to be the most straightforward – is there a “For Sale” sign out front, or not? – it isn’t always that simple. Yes, properties listed for sale generally have a willing seller, but they also likely have more potential buyers (i.e., competition) which could lead to a higher price. Still, working directly with a seller or a broker to find listed properties can be a great way to find a lot of good opportunities quickly. Alternatively, some excellent purchases can still be found “off market,” either not formally listed for sale or from an owner who wasn’t necessarily focused on selling until a willing buyer (you!) approached them.

**Applying This to You!**

Think about a site that piques your interest. What makes it marketable? What might limit its marketability? Is there anything you can reasonably and cost effectively change to make the property more marketable?

## II. Resources for Site Selection

Clearly there is a lot of information that must be pulled together when learning about and selecting a site. Some of this information may be obtained simply by observation and much of it should be provided by the seller. However, what if you are not able or willing to speak with a seller, or want further validation. A great deal of this preliminary site selection information can be gathered from various online sites, including government and broker sites. In Minneapolis, the following are good resources.

1) *Minneapolis Property Info*

   http://www.ci.minneapolis.mn.us/propertyinfo/index.htm

   The City of Minneapolis Property Info site has much of the same information as the Hennepin County site, but also provides details on zoning, inspections, rental history, and business licenses. The Minneapolis site also lists the neighborhood and Police precinct where the property is located.

2) *Minneapolis Planning and Zoning*

   http://www.minneapolismn.gov/cped/planning/index.htm

   Minneapolis's Planning and Zoning site has detailed zoning maps covering all city properties. This high-level view can be helpful to understand areas intended for residential, commercial, etc. and zoning of sites adjacent to your target property. This site also includes a link to the city's zoning code (Code of Ordinances, Title 20), which provides extensive detail on allowed uses, setbacks, height limits, and other important site development information. Finally, the Planning and Zoning site includes a link to the city's comprehensive plan, which details the city's long term vision for property use and development. Understanding this can be helpful to spot future opportunities and to align your own development goals with those of the city.

3) *Minneapolis Sector Liaisons*

   http://www.minneapolismn.gov/cped/cped_about

   If you have additional questions about a property related to planning, zoning, and development, good resources are Minneapolis's Planning Sector Liaisons. This link to the CPED/About Us page includes a link to a map and contact information for each Sector Liaison.

4) *Minneapolis Communities and Neighborhoods*

   http://www.mncompass.org/profiles/neighborhoods/minneapolis-saint-paul#!community-areas

   Minnesota Compass is a good resource for information on Minneapolis neighborhoods. Profiles can be pulled up online at either the community or neighborhood level. Profile information includes current detailed demographics and some historical information. The Minneapolis Property Info website includes a link to the neighborhood profile of each property.

   http://www.minneapolismn.gov/maps/neighborhoods

   http://www.ci.minneapolis.mn.us/neighborhoods/

   The first link includes maps for each Minneapolis neighborhood, including an overall city neighborhood map. The second link provides detailed information by neighborhood including demographics, labor, and housing information.

Demographic information tends to be older than that provided by Minnesota Compass, but also includes more historical information. Each neighborhood section also includes maps such as zoning, current land use, and future land use.

5) *Hennepin County Property Information Search*

   http://www.hennepin.us/residents/property/property-information-search

   Hennepin County puts all public information about every property in the county on this website. Properties can be looked up by address, property ID (PID), or map. Information on this site includes size and dimensions, ownership, assessed market value (for tax purposes), property taxes and assessments, and sale information.

6) *Traffic Counts*

   http://minneapolis.ms2soft.com/tcds/tsearch.asp?loc=Minneapolis&mod

   http://dotapp9.dot.state.mn.us/tfa/

   Minneapolis has a great website that enables users to look up traffic counts (by street or interactive map.) The site provides both current as well as historical traffic counts.

7) *Broker Sites*

   http://www.mncar.org/public-commercial-listing/

   http://www.loopnet.com/

   http://www.themlsonline.com/minnesota-real-estate

   Several real estate broker sites exist that can be great sources of information for everything from properties for sale, asking prices, asking rates for leases, and site details for listed properties. MNCar runs the dominant commercial site in Minnesota. MNCar provides the public access to sale and lease listings with basic information, though detailed information requires a paid membership available only to those with a real estate license. LoopNet is another commercial real estate listing site that is similar to MNCar's site. Residential oriented sites such as The MLS Online will primarily list single family homes. However, these sites are often good sources for duplexes, small apartment buildings, and even some small commercial properties.

## III. Inventory Comparison

You will find that much of the information you uncover during your early stages of site selection you will use frequently throughout the acquisition and development of the property. Therefore, it is recommended that you keep all critical information together in a single location to avoid repetitive searches. In addition, to easily compare opportunities, it is helpful to organize this information in a manner than easily displays similarities and differences among properties. Therefore, you may want to use an Inventory Comparison as is shown on the following page. Like when shopping for electronics or other products, online sites enable you to compare specifications across columns, the Inventory Comparison allows you to quickly and easily compare specs across properties. This template also helps to ensure you thoroughly investigate potential purchases and quickly identify missing information.

## Sample Inventory Comparison

| Building Name | Option 1 | Option 2 | Option 3 | Option 4 |
|---|---|---|---|---|
| *BASIC BUILDING INFORMATION* | | | | |
| Address | 123 Main St. | 2300 Chicago | 900 N 2nd St | 1400 Lake St |
| City | Minneapolis | Minneapolis | Minneapolis | Minneapolis |
| Zip | 55408 | 55423 | 55454 | 55450 |
| Previous Sale Date | 9/14/2006 | 5/17/2015 | 6/21/2005 | 6/23/2009 |
| Previous Sale Price | $624,850 | $985,000 | $453,000 | $789,000 |
| Estimated Market Value | $850,000 | $1,015,000 | $759,500 | $1,256,000 |
| Number of Units | 2 | 2 | 2 | 2 |
| Parcel ID (PID) | 0474824120007 | 0474824120004 | 0474824120006 | 0474824120005 |
| Legal/Abstract or Torrens | Torrens | Torrens | Torrens | Torrens |
| Lot Size | 9,000 | 6,000 | 5,500 | 5,000 |
| Lot Dimensions | 100x90 | 120x50 | 110x50 | 125x40 |
| Gross Bldg SF | 6,000 | 7,200 | 5,000 | 8,300 |
| Net Bldg SF | 5,000 | 6,200 | 4,500 | 7,500 |
| Building Efficiency | 83% | 86% | 90% | 90% |
| Number of Levels | 2 | 2 | 2 | 3 |
| Basement (Y/N) | N | N | Y | Y |
| Elevator | N | N | N | Y |
| Dock | N | N | N | N |
| Year Built | 1975 | 1958 | 1923 | 2001 |
| Historic (Y/N) | N | N | Y | N |
| Clear Heights (Interior) | 12 | 9 | 10 | 12 |
| Vehicle Counts (X cars/day or VPD) | 10,500 | 4,300 | 19,450 | 23,950 |
| Parking | 10 | 8 | 0 | 12 |
| | | | | |
| *ZONING* | | | | |
| Current Use | Residential | Residential | Mixed Use | Mixed Use |
| Proposed Use | Residential | Mixed Use | Mixed Use | Mixed Use |
| Current Zoning | R2 | R2 | R3 | C2 |
| Proposed Zoning | No change | No change | No change | No change |
| Height Restriction | 2.5 stories/35' | 2.5 stories/35' | 2.5 stories/35' | 4 stories/45' |
| Proposed Height | 28' | 23' | 25' | 40' |
| | | | | |
| *SITE EVALUATION* | | | | |
| Access | Excellent | Good | N/A | Good |
| Visibility | Poor | Excellent | Good | Good |
| Signage | Monument | None | None | Monument |
| Neighborhood | Uncertain | Good/Stable | Strong | Emerging |
| Building charm/character | Good | None | Excellent | Very Good |
| Proximity to LRT/Transit | 5 blocks | 1 block | 2 blocks | 1 block |

## Activity C: Site Selection Research

# Site Selection Questionnaire

**Instructions:** Answer the following questions using resources described in this section.

1 _____________ What is the assessed market value and annual taxes for 1719 Franklin Ave W in Minneapolis?

2 _____________ What is the Property ID (PID) for the Russian Museum (5500 Stevens Avenue S) in Minneapolis?

3 _____________ Who is the taxpayer for the McDonald's at the NW corner of Lake St E and 31st Ave S in Minneapolis?

4 _____________ What is the lot size for the Bakken Museum (3537 Zenith Ave S, Minneapolis) in square feet?

5 _____________ Find the property immediately to the west of 1850 38th St E, Minneapolis. When was it last sold and what was the purchase price?

6 _____________ In the Midtown Phillips neighborhood, what percentage of occupied housing is occupied by renters?

7 _____________ What is the median monthly rent paid in the Willard-Hay neighborhood?

8 _____________ What were Total Estimated Market Values for 3100 Excelsior #102 in year 2009 and 2013?

9 _____________ In what zoning district(s) is the Surly Brewery (520 Malcolm Ave SE, Minneapolis)?

10 _____________ Are there any pending assessments on 2815 Johnson Street NE, Minneapolis?

11 _____________ Is a car wash a permited use at 4553 34th Ave S, Minneapolis?

12 _____________ What was the Median Household Income in the Seward Neighborhood in 1999?

13 _____________ Based on TheMLSOnline results, how many multifamily buildings are listed for sale in the Minneapolis school district (#1) for $500,000 or less?

14 _____________ What is the most recent traffic count on W Lake St between Nicollet Ave and Blaisdell Ave?

15 _____________ Between 2012 and 2016, did traffic on Cedar Ave S, between E 24th and E 25th Street, increase or decrease?

16 _____________ What was the most recent *official* (not draft) traffic count on Mainstreet between 9th and 10th Avenues in downtown Hopkins?

17 _____________ How many retail spaces are available for lease within a 1-mile radius of Hennepin & Lake in Uptown? What is the range of asking rates for those locations?

18 _____________ Who would you contact if you had planning questions for a property in the Folwell neighborhood?

19 _____________ Based on LoopNet results, how many industrial or office buildings smaller than 20,000 square feet are listed for sale in Minneapolis?

20 _____________ Based on a MNCar search, how many buildings are for sale in Minneapolis that sit on 0.25 to 0.50 acres?

*Note: Properties chosen at random for educational purposes only.*

# Section 4: Acquisition, Due Diligence, and Entitlements

## Key Concepts

- Though every real estate purchase will have its own unique circumstances, the overall process includes four distinct steps: Letter of Intent, Purchase Agreement, Due Diligence, and Closing.
- The due diligence period is your opportunity to learn as much as you can about the property, secure funds to pay for it, obtain approvals for planned changes, and confirm it is still a good financial investment.
- Any significant change in use or construction on the property will require municipal approval. The approval process includes submitting an application, site plans, and drawings to the city; participating in Planning Commission and City Council meetings; and ultimately receiving a vote for or against your plan.
- The zoning code includes several items which control how a structure can be built on a property. These controls are intended to manage density and ensure complementary design and effective use of the property with the surrounding area. Understanding any restrictions to building is important so that you can plan and design your development accordingly.

## I. Acquisition process

**Letter of Intent -** Once you have found a property you want to buy, there are several steps you must take before you own it. After preliminary conversations with the owner (directly or via your real estate agent) you will draft a Letter of Intent (LOI) or term sheet, which outlines the terms of the purchase at a high level. The LOI would include items, in simple language, such as purchase price, due diligence period, and major contingencies to close. Importantly, the LOI should also include language that it is non-binding, meaning that it is only a “handshake” agreement, and technically can be broken at any time without financial and legal implications.

**Purchase Agreement –** Upon agreement of terms in the LOI by both the buyer and the seller, both parties work on a longer, legally binding agreement known as the *purchase agreement*. Since commercial and residential investment purchases are more complicated than buying a single-family home, buyers often pull in a real estate attorney to draft the purchase agreement, though a knowledgeable real estate agent or the buyer himself is able to do so. The purchase agreement will formalize the terms outlined in the LOI as well as add in other standard or more minor terms to describe the closing process and protect the buyer and seller. In short, a purchase agreement will detail 1) answers to the basic questions (who, what, where, when, how much), 2) what each side will do before and at closing, and 3) contingencies, or why and how either side (mainly the buyer) can back out of the agreement.

**Due Diligence** – Once the purchase agreement has been executed, the property is "under contract" and the due diligence period begins. While the seller does have some responsibility during this period to provide information she has about the property, most of the work falls to the buyer. The purpose of the due diligence period is to confirm:

1) you fully understand what you are buying
2) the seller can legally sell it and you can legally buy it
3) you have the money to buy it
4) you can develop it the way you intend, and
5) it makes sense for you to buy it (financially and otherwise)

Ideally, you answer these questions before closing on the property or, even better, before any of your earnest money "goes hard" (i.e., is non-refundable.) However, a seller will not always be willing to agree to so many contingencies in the purchase agreement. For example, a seller may agree to give you 30 days to inspect the property, do an environmental study, and get financing, but may not be willing to wait for you to get an agreement from a future tenant. What due diligence is included as a contingency in the purchase agreement comes down to negotiations between the buyer and the seller. A detailed listing of the most common activities during due diligence is presented in the Due Diligence Checklist below.

**Closing** – After the due diligence period is over and all contingencies have been met or waived, the last major event is to close. Of course, there is a lot that happens at closing, including transfer of title, transfer of funds, completing financing, settling payments for taxes, paying commissions and fees, etc. To make all of this come together at closing, the title company, lender(s), attorneys, brokers, buyer, and seller, are spending time in the days and weeks prior to closing, getting all paperwork in order and arranging for funds to be transferred. When everything is in order – which always seems to occur the day or hours before the closing is scheduled – the seller is paid, the buyer receives the deed, and the transaction documents are recorded with the county. The transaction is complete!

### Applying This to You!

Before signing a purchase agreement for your property, review the due diligence section to make sure it gives you the right to answer these questions to your satisfaction or walk away from the deal without significant consequences. Do you fully understand what you are buying? Are you certain the seller can sell it and you can buy it? Do you have the money to buy it? Can you develop it the way you want? Does it make sense for you to buy it?

## II. Due Diligence Checklist

A commercial purchase (including larger multifamily residential) is unique from a residential purchase, because there are limited requirements on the seller protecting the buyer. Therefore, it is important for you to be thorough with your due diligence. While the following is by no means a complete list, some of the most common due diligence activities are detailed below.

| | |
|---|---|
| **Financing** | If you need a loan to purchase the property or do your construction, you will want to be sure that closing on the property is contingent on getting financing. (Note: Lenders will often require many of the other items on this checklist be completed, even if you do not think they are necessary.) |
| **Title** | You will need to confirm that the seller is actually the owner and is legally able to sell you the property. You will likely not want to purchase the property until it has a "clean" title (i.e., free of liens, etc.) |
| **Survey (ALTA)** | A survey will confirm the property boundaries and indicate if there are any easements, or similar restrictions on the property. |
| **Environmental (Phase I & II)** | An environmental services company should conduct a Phase I environmental assessment, which includes an on-site visit, and review of public records, property history, and adjacent properties to determine if it is at risk of environmental contamination. If a reasonable risk is present a Phase II should be conducted which would involve testing soil and groundwater samples. |
| **Property Inspections** | You will want to conduct a thorough inspection of the building and grounds to understand if anything needs repair and/or will cost money to fix in the near future. In particular, items such as the roof, parking lot, foundations, heating and cooling systems, and potential asbestos issues should be inspected. |
| **Appraisal** | A lender will require a property appraisal to determine the value of the property. The appraisal will be based on recent comparable sales and may also consider the income generated by tenants. |
| **Licenses & Permits** | Like zoning and use approvals, you will want to inspect to be |

| | |
|---|---|
| | sure any uses that require licenses or special permits can be obtained. |
| **Zoning/Use Approvals** | If you intend to do construction or change the current use of the property, you will want to understand if your plans will be acceptable and, ideally, get fully entitled before closing. Because a full approval process can take several months and adds risk, a seller may be reluctant to make closing contingent on getting all zoning and use approvals. If a seller does not agree, you must determine if that is a risk you want to take. |
| **Taxes & Assessments** | You will need to understand how much in property taxes the owner must pay and if any assessments are due, pending, or being considered. Taxes are typically split on a pro rata basis based on the calendar year. Assessments are subject to negotiation. |
| **Tenant/Lease Review & Estoppels** | If you are buying a property with existing tenants, you will need to understand the intimate details of those tenants. Specifically, you should study all the terms of the lease and any amendments, review payment history, and investigate tenant credit and their business situation. You should adjust your income assumptions based on any risk you identify based on that information. You may also want to obtain estoppels, which serve as legal verification from the tenants that the information you have about them is true. |
| **Property Management Review** | You will want to review property management records to understand how well the property has been maintained. You will also want to refine your estimates for future operating expenses based on historical records, your investigations, and discussions with a property manager, if you intend to hire one. |
| **Financial Review** | Even though you should have conducted a financial feasibility analysis before signing a purchase agreement, you will want to continuously refine your assumptions based on new information you uncover during due diligence. If your financial metrics degrade to unacceptable levels after your knowledge of the property increases, you will want to renegotiate the deal or terminate the purchase agreement. |

# III. Entitlements

## *A. Approval Process – Administrative, Neighborhood Groups, Planning Commission, City Council*

If you plan to develop a property from the ground up, or even redevelop a property that fundamentally changes the use or exterior of the building, you will be required to get approval from the city and potentially other governmental agencies, for the intended changes. Obtaining the approvals necessary to develop your property is called getting the property *entitled*. The process in Minneapolis is fairly typical of most municipalities, and has three major components.

**Administrative –** The first place to start is with the city's planning and zoning staff. The staff will guide you through the approval process, having you complete necessary paperwork, submit drawings, and discuss schedule. If the approvals you need can be obtained at a staff level, they will grant or deny you approval when everything is submitted. If approval cannot be done administratively, the planning and zoning staff will submit a staff recommendation to the Planning Commission and City Council. The recommendation will generally be based on whether the development plan is in line with current zoning, the city's long-term plan, uses and design that complement the area, and area impacts to traffic, environment, etc. While Planning Commission and Council can choose to uphold or go against the staff recommendation, the recommendation carries a lot of weight, and so it is beneficial to submit a plan that has staff support.

**Planning Commission** – If a plan cannot be approved administratively, the first major step is a Planning Commission hearing and vote. The Planning Commission will need to review the information in your application, which will include a description of the development, site plans, and schematic drawings (renderings of what the building will look like.) Having good partners to lead this work; namely a civil engineer, architect, and possibly an attorney; who are familiar with the approval process and can help make sure everything is in order can improve your chances of getting approval in a timely manner. The Planning Commission typically requests that the developer has had discussions with the neighborhood and will often ask for feedback from the neighborhood leadership. During the approval hearing you will be given the opportunity to present your development, planners will ask questions, and the general public will have an opportunity to speak in favor or against the plan. Finally, the members of the planning commission will vote on whether to approval or reject your project.

**City Council** – The Planning Commission is a required step, but their vote is not the final say. After the Planning Commission vote, usually a few weeks later, your plan must also go before City Council. Much like at the Planning Commission meeting, council members will review plans and drawings, listen to your presentation, ask questions during a council meeting, and allow input from the public. While City Council has full authority to approve or deny the plan, they heavily consider the staff recommendation and the Planning Commission vote. If City Council votes in favor of your plan, you are approved to proceed (though you will still need to get building permits, etc.) If your plan is not approved, you can usually rework the plan and go back through Planning and City Council at a later date.

While this process is typical for most municipalities, the exact steps and requirements may vary depending on the nature, size, and location of a project. For example, a developer may be required to perform an environmental assessment or seek approvals from additional governmental organizations such as a watershed district. For this reason, it is important to reach out to the planning staff early and involve experts who can ensure nothing is missed.

### Applying This to You!

Put together a schedule that outlines each of the key milestones in the entitlement process for your development. Reach out to the city's planning and zoning staff contact to discuss and refine your schedule.

## *B. Zoning & Buildable Potential*

Beyond restricting the type of uses allowed on a property, the zoning code (http://www.minneapolismn.gov/zoningmaps/zoning_code_index) specifies several other factors that will impact how a site can be built. The purpose of these restrictions is to ensure functionality in site design, both individually and collectively, and to support complementary design within an area. For example, you may not be too happy if someone built a 20-story apartment building fifteen feet away from your single-family rambler. Understanding the various site constraints and designing a building that is allowed within those constraints but is still financially feasible is one of the puzzles that developers must solve – this is one way developers add value. Several of the most notable restrictions that impact site design and should be understood early in the site selection and due diligence are listed on the next page.

**Did you know?**

*In 1899, congress passed the Height of Buildings Act which limits building heights in Washington D.C. to 110 feet, in order to maintain the visible prominence of several government monuments.*

# Notable Zoning Restrictions

| | |
|---|---|
| **Height Limits** | Zoning often will limit the height of a building in order to preserve the character of a street or neighborhood and/or to limit density on a site so as to prevent excessive burdens on infrastructure like roads and sewers. |
| **FAR** | Floor-to-Area ratio, or FAR, is calculated by dividing a building's total (gross) floor area by the size of the land upon which the building is built. Like height limit, the FAR is used to limit density on a property. For example, a 2-story building with 5,000 SF on each floor (10,000 SF total) built on a 20,000 SF property would have an FAR of 0.5 (10k SF / 20k SF). |
| **Setbacks (aka Yard Requirements)** | Properties often will have minimum or maximum setbacks. While this can help control density, it is primarily used to maintain a certain character, ensure adequate site lines, and prevent buildings from being too close together. You might not be too happy if your living room window was right on your lot line and then your neighbor build a garage six inches away in his lot. Setbacks are often exist, but may differ, for front, back, and side yards. While cities have had minimum setbacks in place to prevent crowding, more recently, cities are focusing on maximum setbacks to encourage and active the streetscape. |
| **Lot coverage** | Lot coverage is similar to FAR, but only looks at the building footprint, rather than the total floor area of the building. The largest building footprint you could build on a 20,000 SF lot with a maximum lot coverage of 0.70 would be 14,000 SF. Like setbacks, lot coverage is primarily used by municipalities to limit crowding of buildings and ensure some open space. |
| **Impervious Surface Coverage** | Impervious surface coverage is a maximum percentage of the lot area that can be covered with surfaces that do not allow drainage, such as building and parking lots. The intent of this is to promote landscaping and prevent excess rainwater from burdening sewer systems. |
| **Parking** | Parking requirements are typically based on use. For example, a retail building will require more parking than an industrial building. Cities may have a minimum parking ratio to ensure the property can support the projected vehicle counts without excessive overflow on to the streets or nearby properties. Cities may also have a maximum parking ratio to prevent a "sea of parking," encourage alternative forms of transportation, and to promote a certain character for a neighborhood. |

# Activity D: Buildable Area Analysis

## Directions

1. Using the Hennepin County Property Search website and the City of Minneapolis Zoning Code, look up the information listed for each property listed below. Assume the Planned Use is as noted in the table.
2. Calculate the maximum gross building size you could build based on the information you researched.

### LOT A

| | | |
|---|---|---|
| **Property** | 1801 Dupont Ave N, Minneapolis<br>*NW corner of 18th Avenue N & Dupont Avenue* | |
| **Planned Use** | Multi-Family Apartment building | |
| | **Calculated Value** | **Requirement/Source** |
| **Zoning Classification** | | |
| **Lot size** | | |
| **Lot dimensions** | | |
| **Minimum Lot Area** | | |
| **Minimum Lot Width** | | |
| **Height Limits** | | |
| **FAR** | | |
| **Yard Requirements** | | |
| **Maximum Lot Coverage** | | |
| **Impervious Surface Coverage** | | |
| **Parking (Min, Max)** | | |
| **Maximum Gross SF** | | |

(page 2)

## LOT B

| | | |
|---|---|---|
| **Property** | 1626 Lake St E, Minneapolis<br>*NW corner of Lake Street E & 17th Avenue S* | |
| **Planned Use** | General retail Sales and Services | |
| | **Calculated Value** | **Requirement/Source** |
| **Zoning Classification** | | |
| **Lot size** | | |
| **Lot dimensions** | | |
| **Minimum Lot Area** | | |
| **Minimum Lot Width** | | |
| **Height Limits** | | |
| **FAR** | | |
| **Yard Requirements** | | |
| **Maximum Lot Coverage** | | |
| **Impervious Surface Coverage** | | |
| **Parking (Min, Max)** | | |
| **Maximum Gross SF** | | |

# Section 5: Introduction to Financial Feasibility

**Key Concepts**

- Real estate is a business, and like any business, financial success means generating a profit, a return on investment, that can be justified based on the risks taken and alternative investments.
- Real estate revenue is created by "selling" space, usually on a temporary basis via a lease. This expected revenue is known as Effective Gross Income.
- A profit is realized from real estate revenue after paying the costs to create and maintain that space. In real estate, revenue remaining after subtracting out operating costs is referred to as Net Operating Income, NOI.
- Real estate financial analysis further breaks down income by removing capital and leasing costs to report Cash Flow before Financing, and then removes debt payments to report Cash Flow after Financing.
- Positive cash flow is important, but is only the first step to ensuring a good investment. The return, or cash flow relative to the investment, must be large enough to justify the risks being taken. Real estate financial analysis looks at various return metrics, but Return on Investment (ROI) and Return on Equity (ROE) are two of the most common.
- Cap Rate, the ratio of NOI to property value, is perhaps the most commonly used real estate ratio, and is used to compare property values and demonstrate risk.

## I. Real Estate is a Business

There are many good reasons to invest in and develop real estate. People enjoy creating a place that can be a benefit to people and the community – a place to live, a place to work, a place to shop or eat, etc. Real estate developers can alter the landscape of a street, building a beautiful new structure or fixing up a storefront that has been neglected for too long. Yet, whether it is the primary incentive or simply a benefit to doing something you love, the financial outcome of a real estate investment must make sense. Real estate, after all, is a business – and a business must make a profit in order to be sustainable.

In its simplest form, business profit is the difference between revenue and costs:

**Profit = Revenue – Costs**

For a business to generate revenue and be viable, it must have something of value to sell. In real estate, that "something" is space; the space is either sold on a permanent basis or temporary basis, via a lease. In addition, a business must have buyers, or customers. In real estate those buyers of your space for a set amount of time are tenants, and the rent they pay is your income, or revenue. (This concept of your tenant as your customer is important to remember. Even though a real estate transaction, with its numerous terms and negotiations, is more complicated and sometimes contentious than buying milk at the grocery store, it still requires a customer; that customer should be valued and respected by the business owner.)

In addition to revenue, the other half of the profit equation that must be considered is cost. Every product or service that is sold has costs – materials, labor, etc. For real estate, the obvious cost is the expense required to build and maintain the building. Indeed, real estate has a whole gamut of costs, including land acquisition, design and construction, repairs and maintenance, taxes, utilities, insurance, borrowing costs, and asset and property management.

Going back to our simple equation, in real estate we must make sure the income being paid to us by our tenants sufficiently exceeds our total cost to provide and maintain the space to those tenants. A detailed document that real estate owners use to estimate, forecast, and analyze the financial aspects of their investment over time is known as the *pro forma.* We will go over the key components of a simple

### Example: Single year financial analysis

We just received an annual rent check (ok, rent is typically paid monthly, but go with me on this) for $50,000 from our tenant – Yay! We're rich!

But not so fast, we realize we have a stack of bills for the property to pay for everything from water & sewer to property insurance to snow removal. Even Tommy down the street who mows the lawn has his hand out. Those bills total $12,000 for the year. Ok, we still have $38,000 – still rich.

Except the tax collector is now knocking on our door. He has his hand out for $8,000. Now we are down to $30,000 – we can still handle that.

But we are smart real estate owners, and we know that if we don't put a little away every year for the big expenses like a new roof, that could be a problem in 10 years. Let's put $2,000 in a capital reserve. Now we have $28,000 – still doing fine.

Except for our banker. How could we forget about our banker? Remember, we had to borrow a fair amount in order to buy this property. That loan costs us $20,000 every year. So, all of the sudden we are down to $8,000. – Hmmm.

So maybe we are not rich, but we still have a profit of $8,000. (And we knew we weren't going to be able to keep the full $50,000 anyway.) Considering we put $75,000 of our own money into the property when we bought it, getting $8,000 back every year actually isn't too bad – that's a 10.6% return.

financial analysis (a single year of the pro forma) next.

# II. Single Year Financial Analysis

## A. Gross Income, Net Effective, NOI, Cash Flow

A single year real estate financial analysis is simply a means of documenting revenue and expenses to determine profit and calculate investment metrics. This analysis can be fairly simple and straightforward, as demonstrated in the above example, or it can be quite involved. Effectively, we begin by building up all of our revenue and then systematically deduct our costs one step at a time, revealing key metrics along the way.

Here is an outline of a single year financial analysis

| | |
|---|---|
| A. | Gross Potential Income |
| B. | - Vacancy |
| C. | **Effective Gross Income** |
| D. | - Operating Expenses (RE Tax, Insurance, Maintenance, Utilities, Reserves) |
| E. | + Reimbursed Expenses (Commercial only, not residential) |
| F. | **Net Operating Income (NOI)** |
| G. | - Capital and Leasing Costs |
| H. | **Cash Flow (before Financing)** |
| I. | - Debt Service |
| J. | **Cash Flow (after Financing)** |

**Effective Gross Income**

We begin by building up our revenue to capture all of the potential income we could receive. With a single tenant, this is fairly straightforward. However, if our property has multiple tenants, in varying sized spaces, paying different rates, this could become much more involved. We also want to add in other income that could come from things like parking, laundry, vending, and fees. All of this together is the *(A)* Gross Potential Income. Then we need to adjust for any ongoing *(B)* vacancy we may have. Because there is always some risk in keeping spaces filled and rent paid, even with a signed lease, and because there can be short term vacancy as tenants turnover, it is common for an analysis to include a vacancy factor. This vacancy factor is often 5%, but should be adjusted based on the level of turnover and risk present. (Note: Fluctuations in vacancy over time may require a multi-year pro forma as described in Chapter 8.) Once all of this vacancy is deducted from the Gross Potential Income, we are left with the *(C)* Effective Gross Income.

**Net Operating Income (NOI)**

In order to calculate a *(F)* Net Operating Income we must deduct the *(D)* Operating Expenses from the Effective Gross Income and add back *(E)* Reimbursed Expenses. Operating expenses include all expenses incurred as part of the day-to-day operations of the property. Typically, the most expensive are property taxes and insurance, though others can be significant as well. Below is a list of common operating expenses:

- Property taxes
- Property insurance
- Water and sewer
- Utilities
- Garbage collection
- Landscaping
- Snow removal
- Property management
- Maintenance and repairs
- Administrative and accounting
- Janitorial service
- Pest control
- Advertising

***Rule of 100***

Building Evaluation Reference Point

Need $1 in rent per month for every $100 in cost

*Example*

4 Unit Building

Each Unit Rent: $1,200 a month

Total Building Income: $4,800 a month

Building cost not to exceed: $480,000

Residential leases are usually gross leases, meaning the tenant pays a fixed rate and does not pay the landlord separately for operating costs (though the tenant may pay certain utilities that they are billed for directly by the provider.) Commercial leases are often more complicated because they typically net out certain expenses from the base rent. For these expenses, the landlord pays the cost upfront and then the tenant reimburses the landlord for that amount. (Typically, these costs are reimbursed by tenants on a pro rata basis based on the size of each tenant's space relative to the size of the entire property.) What a tenant reimburses a landlord for is spelled out in the lease. For example, things like the property management fee percentage and what qualifies as a reimbursable repair could be negotiated differently by each tenant. If there are many leases, each with different terms, sorting out reimbursements can get fairly complex. Also, when estimating reimbursed costs, it is important to account for any potential vacancy that may exist, as tenants will not be around so the landlord has to absorb those costs.

After operating expenses are deducted and reimbursements are added back in, we are left with the Net Operating Income (NOI.) The NOI is one of the most fundamental metrics in real estate investment because it is used in property valuation as we will soon discuss. (NOI is roughly equivalent to EBITDA for those familiar with corporate finance.)

**Cash Flow before Financing**

As we discovered in our example above, our expenses do not stop after we pay our operating expenses. There are other expenses that we must subtract from the NOI to get a better handle on the actual financial situation. These other expenses are *(G)* Capital and Leasing Costs that are necessary for long-term upkeep and upfront costs to bring in a tenant. The three most common costs in this section are:

- **Tenant Improvements** – Costs to build out space for a specific tenant (or given to a tenant if the tenant is doing the build out himself)
- **Leasing Commissions** – Fees paid to real estate brokers for finding a tenant and negotiating the lease
- **Capital Costs/Reserves** –Variable (often significant) property expenses such as a new parking lot, roof, or elevator upgrade. Sometimes a financial analysis will include a fixed amount every year as a way to budget for these large, irregular expenses

Once these additional expenses are deducted from NOI, we are left with *(H)* Cash Flow before Financing, CFBF, or Unlevered Cash Flow. Though NOI is a more common metric, CFBF is arguably more important as it reflects a more realistic picture of actual income generated by the property. In fact, when evaluating a property, it is important to understand what is included or excluded from NOI v. CFBF – sometimes NOI can be deceptively high (making the property seem more valuable) if expenses are deducted after NOI when they should be included in the NOI calculation.

**Cash Flow after Financing**

As we saw in our example, lots of people need to get paid, so we don't stop at CFBF. If there is debt on the property, we need to consider the *(I)* Debt Service as well. Debt service is simply the ongoing cost of servicing that debt – principal, interest, and other related costs. When we subtract debt service from all of our loans from CFBF we are left with *(J)* Cash Flow after Financing, CFAF, or Levered Cash Flow. We separate this debt service out from other line items in the financial analysis because loan payments will vary by loan terms. They are unique to each individual buyer (borrower) and do not affect the actual value of the property.

In reality, yet another step could be taken that is not shown here and is often excluded from real estate financial analyses. This step is a further adjustment to cash flow for income taxes. However, that is even more unique to each individual, and can depend on the investor's tax situation, which may be broader than this single property.

### Applying This to You!

Make a list of all the operating expenses you expect to incur for your property. Then, start to estimate how much each of those individual expenses will cost. Keep track of your assumptions so that you can refine them as you learn more. Is each cost a flat fee, a certain cost per square foot, a certain cost per unit, etc.? Reach out to service providers and other owners to see if your assumptions seem accurate or need refinement. (Hint: See template on next page.)

## *B. Key Return Metrics: Return on Investment and Return on Equity*

Knowing our revenue, costs, and the difference between the two is critical to determining if a property is generating a profit. However, simply knowing a real estate investment is cash flow positive does not tell us if is a good investment. If we are looking at two opportunities, and one provides a $5,000 profit and the other provides a $10,000 profit, we may assume the second is the better investment. However, if our required investment for the second is four times greater than the first for only double the profit, we are better off with option A. Therefore, when analyzing a real estate opportunity it is important to also determine to critical return metrics: Return on Investment and Return on Equity.

**Return on Investment (ROI)**

While there are many different ways to calculate Return on Investment (ROI) depending on the structure of the investment, the basic concept is to divide what you are getting out of the investment by what you are putting in. For example, when flipping a property, if you buy a building for $200,000, put $120,000 into it, and sell it for $400,000, your ROI is 25%

$$\text{ROI} = \frac{\text{Total Return}}{\text{Investment}} = \frac{\$400{,}000 - \$320{,}000}{\$320{,}000} = 0.25$$

In the previous example, we are looking at the total return on investment regardless of the time period. However, when we calculate the (annual) ROI for an income producing property that we are holding, the return we use is the annual return, or more specifically, the Cash Flow before Financing.

If we use the same example as before, but instead of selling the rehabbed building for $400,000, we hold onto it and it cash flows $30,000 per year before we pay our annual financing cost, it has an Annual ROI of 9.4%.

$$\text{Annual ROI} = \frac{\text{Cash Flow before Financing}}{\text{Investment}} = \frac{\$30{,}000}{\$320{,}000} = 0.094$$

# Operating Expense Template

**PROPERTY OPERATING EXPENSES**
**Property Name:**

| | $ per Year | Fixed or Variable (per SF, per Unit) | Variable Cost (if applicable) | Comments |
|---|---|---|---|---|
| **Payroll** | | | | |
| Manager/Caretaker | | | | |
| Leasing | | | | |
| Maintenance | | | | |
| Other | | | | |
| **Management** | | | | |
| **Maintenance & Repair** | | | | |
| Maintenance | | | | |
| Plumbing | | | | |
| Irrigation | | | | |
| Electric | | | | |
| Roof | | | | |
| Supplies | | | | |
| Window cleaning | | | | |
| Exterminating | | | | |
| **Grounds** | | | | |
| Snow | | | | |
| Landscaping/Irrigation | | | | |
| Parking Lot/Garage Repair | | | | |
| **Utilities** | | | | |
| Electricity | | | | |
| Gas | | | | |
| Water/Sewer | | | | |
| Phone | | | | |
| Trash | | | | |
| **Advertising/Marketing/Leasing** | | | | |
| **Administration** | | | | |
| License/Permits | | | | |
| Gen Admin | | | | |
| **Professional Fees** | | | | |
| Legal | | | | |
| Accounting | | | | |
| Other | | | | |
| **Security** | | | | |
| **Real Estate Taxes** | | | | |
| **Insurance** | | | | |
| **Miscellaneous** | | | | |
| **Total Operating Expenses** | | | | |

*NOTE: Template may not be comprehensive of all required property expenses.*

**Return on Equity (ROE)**

Return on Equity (ROE), also called Cash-on-cash return in real estate, is similar in concept to the ROI, but it takes into consideration if an investor takes out a loan to make the investment. If an investor has a loan, their return will be less (since they have debt to pay off), but the amount of equity they put into the investment will also be less. In the flip example we used to calculate ROI, let's assume we bought the property with our own $200,000, but borrowed $120,000 to fix it up. When we sell the rehabbed property for $400,000 we have to pay off our $120,000 loan plus $8,000 in interest. Therefore, our net income from the sale is $272,000, but our equity is only $200,000. This produces a Return on Equity of 36%

$$\text{ROE} = \frac{\text{Total Return}}{\text{Equity Investment}} = \frac{\$272{,}000 - \$200{,}000}{\$200{,}000} = 0.36$$

Also, like with ROI, if we are holding rather than flipping a property, we will want to understand our annual cash-on-cash return, or Annual ROE. If our Cash Flow before Financing is still $30,000 and our annual debt service is $8,000 then our Cash Flow after Financing is $22,000. On a $200,000 equity investment, this gives us an annual ROE of 11%

$$\text{Annual ROE} = \frac{\text{Cash Flow after Financing}}{\text{Equity Investment}} = \frac{\$22{,}000}{\$200{,}000} = 0.11$$

ROI and ROE can be even more involved when analyzing an investment that has both ongoing rental income over a long period of time as well as a final sale of the property. We will cover these situations, along with a couple other important investment metrics when we look at multi-year pro formas in a later section.

## Applying This to You!

What kind of return makes sense for you? Consider the money you will be putting into this real estate investment. If you decided not to do this deal, how else would you invest your money? How does that return and risk compare to this real estate deal?

________________________________________________________

________________________________________________________

________________________________________________________

________________________________________________________

________________________________________________________

## Activity E: Investment Comparison

# Single Year Financial Analysis

## Directions

1. Create a single year financial analysis for each property below. Calculate NOI, Cash Flow before Financing, Cash Flow after Financing, Return on Investment, and Return on Equity.
2. Which property do you consider to be the best investment? The worst? (Hint: Consider all your investment criteria, not just financial.)

### PROPERTY A

The first property you are considering is an empty, single-story retail building with 4,300 SF. The purchase price would be $400,000 but your contractor has estimated it will need another $150,000 in construction and tenant improvements to make it leasable. You estimate you can charge $14.50/SF in rent. Once the property is stable, your operating expenses would be $3.75/SF and your taxes would likely be $11,000 per year.

### PROPERTY B

The second property you have looked at is a three-level building with retail space on the first floor and office space on floors 2 and 3. A single tenant currently occupies floors 2 and 3 taking up 6,200 SF, but the first-floor space is empty and needs some work. The existing tenant is paying a net rent of $13.00/SF, and you estimate that you could lease the 1st floor space out at $16.00/SF in net rent. Total operating expenses for the building are $14,700/year and taxes are $11,550/year. You estimate that you can purchase the building for $600,000 and your contractor has quoted you $70,000 to build out the first floor.

### PROPERTY C

The third property you are considering is a fully occupied, two-story commercial building. A coffee shop occupies the ground level and a small law firm rents space on the second level. Both tenants have 2,600 SF. The coffee shop pays $13.50/SF and the law firm pays $11.50/SF. Both tenants have been there a while, have several years left on their leases, and are doing well; you do not anticipate they will leave anytime soon. Taxes and operating expenses for the entire building are $14,300. The building is on the market for $800,000, but your broker estimates that you can purchase it for $750,000. It does not require any capital improvements.

## Assumptions for all Properties

You have spoken to your bank and can obtain a loan for 70% of the total cost for acquisition and construction for either of these investments. The bank would amortize your loan over 20 years and charge you an interest rate of 5%.

You assume a vacancy rate of 5% for all investments. All leases are net leases so the tenants would reimburse operating expenses and taxes; however, remember to adjust for your 5% vacancy rate.

For purposes of this exercise, assume there are no additional costs to lease out space (i.e., broker commissions) and assume that there are no additional acquisition costs beyond the purchase price.

## III. Cap Rate

The Capitalization Rate ("Cap Rate") in real estate is perhaps the most referenced metric in real estate finance. It is used to give investors, brokers, and lenders a quick way to compare investments, estimate value, and determine risk. While it is often defined by its calculation, it is important to understand why this formula is important and what it actually means.

### *A. Cap Rate: Defined in Math*

The Cap Rate equation is simply:

$$\text{Cap Rate} = \frac{\text{NOI}}{\text{Property Value}}$$

It is equally as important to look at this formula in the following way:

$$\text{Property Value} = \frac{\text{NOI}}{\text{Cap Rate}}$$

We will explain the meaning and importance of those equations in a moment, but first let's look at an example.

### *B. Cap Rate: Defined in English*

*3 Properties…Same NOI…Same Price?*

| | | |
|---|---|---|
| NOI = $100,000 | NOI = $100,000 | NOI = $100,000 |
| Low Risk | Medium Risk | High Risk |
| Cap Rate = 6% | Cap Rate = 8% | Cap Rate = 10% |
| Value = $1.67 million | Value = $1.25 million | Value = $1.00 million |

Let's assume we are looking at three properties, each one generates an NOI of $100,000. Since the value of an investment property depends on how much profit it generates, we might initially think that each property should be worth the same amount. But what if Property A has a very stable, long-term lease with a high credit tenant; Property B has a good tenant but only has 18 months left on the lease; and Property C has a fledgling business in a neighborhood with lots of vacancies? Surely, in that case we be much more willing to pay more for Property A than we would for Property C. This is where the Cap Rate comes in.

*While Capitalization Rate is used to determine the value of a property, it is technically a way to quantify the level of risk that a real estate investment has. The higher the risk, the higher the cap rate.*

Whether it is real estate or any investment, the value of that investment depends on the amount of income it produces *and* the stability of that income. (It also is impacted by the investment liquidity, or how quickly the investor can get his investment back, but we won't focus on that here since real estate generally is not considered to be very liquid.) If that net operating income is highly unstable (tenant may leave or default, getting replacement tenants will be difficult, expenses may spike, etc.) an investor will require a higher return to take on that investment, which will lower what they are willing to pay for that income stream.

> **Remember!**
>
> *Higher Risk = Higher Cap Rate = Lower Price*
> *Lower Risk = Lower Cap Rate = Higher Price*

Going back to our equations, if the property is low risk, we may be willing to pay \$1.67 million for an NOI of \$100,000, giving us a cap rate of 6%. However, if the property is high risk, we may only be willing to pay \$1 million for an NOI of \$100,000, giving us a cap rate of 10%. Said another way, if the more risky property would require us to get a 10% return ("cap rate") on an NOI of \$100,000, the most we would be willing to pay for it is \$100,000 / 0.10 or \$1 million.

## C. How to Determine the Cap Rate

Even when all of this makes sense, confusion of how Cap Rate is determined still exists. There are two ways to answer this. The first is to focus on the concept of "what return would you require to take on that risk?" In real estate, there are many factors that can affect risk including:

- Location strength
- Building layout and amenities
- Asset class
- Market conditions (geography, economy, vacancy)
- Tenant credit and stability
- Building age/condition
- Existing building vacancy
- Management quality (will there be a lot of unexpected repairs coming?)
- Competition

When you consider how stable an NOI will be based on these and other factors, you can begin to calculate how much return you would require, and the cap rate can come from that.

The second part of the answer is to understand that cap rate is regularly estimated based on cap rates of comparable properties. If similar apartment complexes, in a comparable part of town, of similar age and condition, etc. recently sold "at a 6.5 cap" (calculated by dividing the NOI by the purchase price) investors and brokers will use this as a starting point for an apartment complex they are evaluating.

Cap Rate can be confusing because it does represent the return on an investment (NOI/Property Value.) However, while it is similar to annual ROI, it is not exactly the same. Annual ROI is based on Cash Flow before Financing, which is different from NOI, because it deducts capital and leasing costs. While ROI is perhaps a better ratio to indicate actual return, the industry uses NOI in calculating cap rate because it considers Net Operating Income to be a fairer comparison across properties.

# Section 6: Financing

## Key Concepts

- Just like any business, investors and lenders are looking for projects that make good financial sense based on their investment criteria. They will evaluate both you and your project to see if it fits their needs.
- Financing for a real estate investment can come from either equity or debt. Except for funds from family and friends, small scale investments most commonly rely on bank loans.
- There are both advantages and disadvantages of using equity and debt financing. What you use will depend on various factors including the investment, your personal finances, and the level of control you want to maintain.
- When applying for a loan, it is important to understand the key lending terms as well as what a lender considered when determining whether to approve a commercial loan. These considerations cover both the quality of the investment and strength of the borrower.
- Commercial loan approval follows a typical process which includes five stages: Credit appetite, Loan terms, Underwriting & Approval, Due Diligence, and Closing
- Several government programs provide loan guarantees to help residential and commercial developers finance small real estate investments. A developer should understand these options and how to make sure a development qualifies.

## I. Financing Overview

It is not often that a developer, especially one just starting out, has plenty of her own money that she does not need to reach out to others. And even if a developer could fund a project entirely on her own, she may decide to use other sources of funding for financial leverage and diversification – so that she does not have to tie up too much of her own cash in a single investment. What is important to understand is that financial partners, regardless of whether they are providing equity or debt, are not doing you a favor – they are not giving you a gift. Just like this development is a business to you, their investment is a business for them. Financiers and lenders are looking for business partners and investments that can provide them a good risk-adjusted return. They will evaluate your development in much the same way you should be doing – attempting to fully understand the opportunity and risk, and making sure they maximize their ability to make, not lose, money.


In addition, because they want to make smart financial decisions, potential financial partners will be evaluating you to see if you will be a trusted and capable partner. They will look at your knowledge, credit, experience, and performance history, to determine if you know what you are doing and can complete the development. Despite this personal evaluation, do not get discouraged if you are turned down by one or more partners. To be sure, you should take any feedback they provide to heart and make necessary adjustments. However, also understand that lenders and investors, just like developers, are each unique in what they are seeking in an investment. They may be seeking a different type of project to balance their investment portfolio. Alternatively, they may have set specific risk or return requirements that do not align with your project. Simply because one investor (or a few) is not interested in your project, does not mean you will not get funding – make any necessary adjustments and keep calling.

Further, if you are just starting out and do not have any performance history, this does not mean you will not be able to secure financing, though you may be limited by the amount of financing you can obtain or the level of project risk. If you do not have experience and a track record, you may need to start with smaller projects, partner with others who do have a few successful projects under their belt, and/or invest in more stable assets with less risk.

Importantly, even if you have a fantastic opportunity, you will not secure funding if you are unable to articulate the value to your potential partner. It is critical to be fully prepared, well-organized, thoroughly knowledgeable about the investment, and deliver a high-quality written and verbal presentation. Not only will this help answer their questions, but it will give your potential investors confidence in you and your ability.

# II. Financing Options

## *A. Debt v. Equity*

If you need additional financing to make a development work, your first step is to determine if you need debt, equity, or both. Simply put, an equity partner is a partial owner in the development and therefore has higher risk and potentially higher return, while a debt partner is an external partner who is only involved until he recoups his money and the related interest.

Debt partners are lenders, such as a bank. They agree make loans over a certain period of time for an agreed upon return. Assuming all goes as planned, they will recoup their principal and interest per the agreement, but nothing more. Once the loan is paid off, the lender is no longer involved. The lender is not an owner and therefore does not have the financial upside, nor the liability, of being an owner. This does not mean, however, that a lender does not have any control. Often debt partners will include controls in their agreements that give them approval rights over lease agreements, limit the developer from taking on additional debt, and manage distributions (i.e., limit how much of the yearly profit can be distributed to equity partners.) Loan agreements often include covenants that require the investment to produce a minimum cash flow in order to maintain a given debt coverage ratio; if the property cash flow falls short, the borrower may be in default and the lender can take over.


On the other hand, equity partners are owners, and experience all of the upside and risk that being an owner involves. Equity partners will typically own a percentage of the development based on the amount of the investment they make. If your project cost is $500,000, you put in $50,000 and a partner puts in $450,000, you would own 10% and your partner would own 90%. Because your equity partner is an owner, he will have a fair amount of control over your project, especially if his ownership stake is 50% or greater. Some equity partners will be “silent partners,” leaving most of the day-to-day operations and decisions to you, but others will be highly involved. Sometimes, developers do not want to bring on equity partners because they must forgo some control and profit. However, because lenders will usually only provide loans up to a certain percentage of the total investment (e.g., 70-80%, though it varies) having an equity partner may be necessary. Further, in addition to capital, equity partners may also provide a good reputation, strong relationships, experience, and other benefits to the investment.

Equity is subordinate to debt, meaning that lenders get paid before owners. This means that equity partners are taking on more risk (if money runs out, they don’t get paid) and therefore they will expect a greater potential return. Because an equity partner is an owner, his return will be tied to the profit the development creates. Debt partners, however, will be limited to getting back the principal and agreed upon interest only.

## *B. Debt Options*

Some of the most common sources for debt financing are:

| | |
|---|---|
| **Banks** | Includes both large and community; Banks will loan funds from another party or their own funds (portfolio lender) |
| **Credit Unions** | Like banks, but privately owned by members |
| **Mortgage Brokers** | Individuals or companies that have relationships with various lenders and act as the intermediary between lenders and borrowers. (Note: The borrower, not the lender, pays the mortgage broker's fee.) |
| **Private Lenders** | Individuals who make loans formally or informally in real estate, including family and friends |
| **Real Estate Funds** | Professionally managed funds raised for the purpose of real estate lending over a set period of time |

## *C. Equity Options*

Some of the most common sources for equity financing are:

| | |
|---|---|
| **Private Investors** | Individuals who invest formally or informally in real estate, including family and friends |
| **Real Estate Funds** | Formal funds raised by a professional fund manager and invested over select time period |
| **Pension Funds** | State and corporate managed retirements funds; usually focused on larger investments |
| **Insurance Companies** | Usually focused on larger investments |
| **Real Estate Investment Trusts (REITs)** | Publicly traded companies that invest in, acquire, develop, and manage real estate; Usually focused on larger investments |

### Applying This to You!

How do you plan to secure additional finances for your development?

If you plan to use debt, do you have enough of your own cash to make up the difference in cost between what the lender will provide and the total cost of the development?

If you plan to use equity, do you know who your equity partners might be? Are you comfortable giving up some control and ownership to others?

## III. Debt Financing / Mortgages

Most small-scale developers, especially those who are just starting out, generally focus on debt financing over equity for various reasons noted below. (Though it is common for small scale developers to pull in family, friends, and other private individuals to be equity participants.) For this reason, it is important for small scale developers to understand the basics of debt financing.

### *A. Advantages*

**Easier to obtain** – Similar to acquiring a mortgage for your house, there are numerous established sources of funding of residential and small scale commercial lending; Equity providers tend to focus on larger investments. Further, equity investors typically do not have a public "storefront" presence like lenders do; finding equity investors can depend on building a network of relationships.

**Range of options** – Debt financing can come from many sources. The federal and local governments have extensive programs to support residential and some commercial development. Smaller residential investments can be purchased with the same mortgages a buyer would obtain to purchase a house. Further, mortgage brokers are available to connect lenders seeking to make small, community based real estate loans.

**Control** – Because a lender does not have an ownership position, the developer retains control and full ownership. This gives the owner power to make decisions (though sometimes big decisions still require lender approval), complete control when the loan is paid off, and all of the profit.

### *B. Disadvantages*

**Collateral** – Lenders will require collateral, or something of value to be pledged as security for repayment of the loan. Often this is the property itself, but could be another property including the developer's own home

**Guaranty** – Similar to collateral, this is a typical lender requirement to protect their ability to get their money back. Unlike collateral that is tied to an asset, a guaranty is tied to a person or business. The guarantor can be the borrower herself or another entity. If the borrower fails to make loan payments, the lender can sue the guarantor to recoup any losses.

**Limited amount** – To keep risk managed, lenders will often limit the loan amount to create a "cushion." The loan amount is typically limited to a certain percentage (e.g., 70-80%) of the value (loan-to-value) or cost (loan-to-cost) of the property and to ensure the debt service does not exceed a certain percentage of the expected cash flow (debt coverage ratio.)

**Payback requirement** – Equity investors accept ownership risk and understand that when a development fails they lose their investment (though they ain't happy!) However, with debt, borrowers are required to pay the lender back regardless of how well or poorly the development is performing.

## *C. Commercial Lending Terms*

As noted in the process overview, determining the terms of the loan occurs fairly early in the loan process. After all, you will want to know before spending too much time if the terms are competitive with your other options and will make sense for you financially. If you are familiar with mortgage financing for your home, you will recognize many of the lending terms, though loans to support an investment do differ in some cases.

**Interest rates** – The amount a borrower must pay for borrowing funds, indicated as a percent of the amount owed over a period of time. Commercial loan interest rates are determined based on three factors: risk, cost of funds, and the loan amount.

- Risk – Lenders will look at both the property/development and the borrower to assess the risk. Commercial loans are generally considered riskier than personal home mortgages so the rates are usually slightly higher
- Cost of Funds – Lenders borrow the money that they loan to you, so they set rates based on their cost to borrow (e.g., U.S. Treasury rates, LIBOR) and then add their profit ("spread") to determine the rate they will charge you
- Loan Amount – Smaller commercial loans often have a higher interest rate than larger loans. This is due to economies of scale – the lender does not make as much money from a smaller loan so he will charge more to make it worth the effort.

**Term** – Term indicates the duration of the loan. While residential mortgages are often 15, 20, or 30 years, a commercial loan will typically have a shorter term. Loans of 3-7 years are fairly common in commercial lending. Loans that cover new construction may be even shorter and are intended to be refinanced once the property is built and occupied.

**Amortization Period** – Amortization is the time-period over which the debt is calculated to be paid off. With residential mortgages the term and amortization period are usually the same (e.g., 30 years) – when the term is over, the entire debt has been paid back. In commercial lending, it is common to have a term, (e.g., 7 years) that is shorter than the amortization period (e.g., 20 years.) This structure enables smaller payments during the term, but results in a lump sum payoff ("balloon payment") at the end of the term. Borrowers will often refinance the loan at the end of the term in order to avoid having to make that balloon payment in cash.

### Tip: Calculating Loan Payments

**Use these Excel functions to calculate payments for loans with constant payments and a constant interest rate**

*PMT = Total payment periodic payment*
*IPMT = Interest payment for a specified period*
*PPMT = Principal payment for a specified period*

**Loan to Value (LTV)** – The Loan-to-Value ratio is a way for lenders to ensure they do not lend out more money than they can recover if the borrower defaults. In the case of default, the lender will take ownership of the collateral (usually the property) and sell it to recoup the loan. They want to be sure that what they sell it for, less any costs they incur in the foreclosure and sale, will cover what is owed in debt. For stable properties, the LTV is fairly straightforward as the value is, well, stable. For new developments and redevelopments, there may be little value initially because nothing has been built and no tenants are in place. In this case the loan-to-value (LTV) will be based on a third-party appraisal of the expected value after project completion or a loan-to-cost (LTC) will be used based on current value (e.g., land value) plus the cost of construction.

**Debt coverage ratio (DCR)** – The debt coverage ratio is a term that is not used in personal mortgages because it is tied to the cash flow an investment property produces. The debt coverage ratio equals the cash flow before financing divided by the debt service (e.g., principal and interest payment.) Lenders use the debt coverage ratio to make sure the borrower's cash flow from the investment will be enough to cover the debt payments plus a bit more. Currently, common debt coverage ratios are around 1.20-1.25; if your annual debt service is $1,000, your investment should be generating at least $1,250 in cash flow each year (to meet a DCR of 1.25.) This gives the lender a bit of a cushion, so that if your cash flow slips a bit, you can still make your debt payments.

## Applying This to You!

What is the expected purchase price of a property you are considering buying? (Assume $350,000 if you don't have a property in mind.) If your lender requires a 75% LTV, how much equity will you need? How much cash flow will the property need to generate to cover your debt service? (Estimate the loan interest rate and amortization.)

## *D. Lender considerations*

Before agreeing to lend you money, a lender will want confidence that you and your development are likely to succeed so that they are paid back in full and make a profit. To assess the level of risk the lender evaluates several items, commonly grouped into the "Five Cs of Credit."

1. **Capacity (Cash Flow)** – One of the most critical items a lender will assess is your plan for development. The core of this will be the financial analysis – you will need to demonstrate that your plan will provide a sufficient return to cover your debt service. Of course, they will be looking for well thought out and realistic expectations for income, costs, etc. and the sources of those assumptions. In some cases, a lender will want evidence to support these assumptions such as an independent market analysis. Your business plan should also demonstrate that you will be able to make non-financial aspects of your development work including acquiring the property, getting it entitled, and getting it leased up.

2. **Capital** – A lender typically does not want to cover the entire cost of the investment to ensure some coverage in case the borrower defaults. Also, lenders want you (directly or as a representative of the equity) to have a cash stake in the development to provide incentive to make sure the project succeeds. As a result, a lender will want to understand about all of the sources of equity going into the deal.

3. **Collateral** – As noted earlier, a lender will want something of value as security to ensure repayment of the loan. They will want to make sure the collateral is sufficient to cover the cost of the loan in case they need to sell it to recoup their investment. If a bank is providing a loan for more than the property is currently worth (which would be needed if you are doing construction), they will want to understand the expected stabilized value and assurances that the construction will be completed (e.g., name of contractor, completion guarantees, bonds, or letters of credit.)

4. **Character** – In addition to evaluating the development, your lender will also want to ensure you are trustworthy and capable. They will look at your resume and want to understand what sort of real estate experience you and your partners have – development, operations, brokerage, financing, etc. While personal character can be subjective and difficult to fully uncover, lenders find it important. People do not like doing business with those they feel are not upstanding citizens, dependable, and honest. Lenders will also look at your personal

Tip: Remember your online presence!

**Just as prospective employers do, lenders will often look online to learn more about your character. Make sure any online searches and social media posts communicate the right message about you.**

assets and debts, known as your Personal Financial Statement (PFS), your tax returns, and your credit history. Your personal financial situation is a good indication of how well you will manage the investment. This is even more critical if you are providing a personal guaranty; lenders will want to ensure that you have the financial means to cover the debt, even if the project falls short.

5. **Conditions** – While the first four Cs are directly tied to you and your investment, this last category is one that is largely out of your control. Lenders will look at current economic conditions at the time of your loan application, both at a macro level and specifically for your situation (e.g., geography, asset type, etc.) If the economy overall is facing pressure, or there is, for example, concern of a residential development bubble, a lender may be hesitant to approve a related loan.

### Applying This to You!

Conduct your own self-assessment to prepare for a lender assessment. For each of the considerations above, how would you grade yourself? Be honest! What factors might prevent you from getting a high score? How can you overcome those limitations?

# IV. Commercial Lending Process

## *A. Where to Start*

If you have never pursued a loan for an investment property, it can seem intimidating at first. However, as with all journeys, it begins with a single step. To begin, start reaching out to several banks with whom you are familiar. Even if they do not offer the type of loan that you need, they should be able to give you some recommendations for lenders who do. You can also look at other similar developments to find out who is providing their financing – sometimes they even advertise it on the property under construction. Talk to other developers and brokers to see if they have any recommendations.

### Tip: Seek out CDFIs

**Community Development Financial Institutions (CDFIs) provide loans to communities underserved by traditional commercial lenders. CDFI designated lenders can be a good source of funding if your property is located within their target market.**

For smaller developments, especially, it is wise to start with local banks for financing. They will be more familiar and focused on lending in your area. Local banks have a desire to make loans available to support the community and likely have personal knowledge of properties, local market trends, contractors, tenants, etc. However, banks do have lending caps which may limit smaller, local banks from financing bigger projects. As your investments grow, you may need to develop relationships with regional or even national banks. In addition, lending specialists at smaller banks may be generalists that focus on many types of commercial loans, not just real estate. If your development has some unique attributes, you may decide it is beneficial to seek out a lender that has experience handling loans related to your situation.

Remember, it is not just the bank who chooses you. You must also choose your bank. This is a business partnership and it must work well for both parties. In selecting a lender, you of course will want competitive terms (e.g., low rate, low fees, appropriate term) but you will also want a bank you can trust. They will need to be your partner throughout the early stages of the development and if they are unable to fulfill their end of the partnership, you may be left scrambling for a new partner late in the process or forced to abandon the opportunity.

Because commercial lending requires a strong ongoing relationship, it is recommended that you reach out to the lender in person. This gives you an opportunity to demonstrate your competence and professionalism, build trust, and get to know your partner on a personal level. When you meet with your potential lender have your PFS and resume on hand and be prepared to ask intelligent questions about their process and requirements. In addition, because you are also interviewing them, be sure to ask questions about how they operate and manage their business. Ask them about their loan policies, who approves your size loan, how to get a proposal, and their success rate in closing loans like yours. Although you will want to give them sufficient information to determine that you and your investment are worthwhile, be sure the information you are providing is simple and concise. Overwhelming a potential lender with details and information will not answer their questions, it will simply overwhelm them and suggest to them that you are not fully organized. Provide them with clear simple descriptions, but have additional information available to get into details if requested.

## *B. Steps to Securing Financing*

Just like most phases of real estate development, the bank lending process follows a fairly consistent process across the industry.


1. **Credit appetite/loan policies** – Upon contacting a bank and being assigned a loan officer, you and the bank will begin to understand if a lending relationship makes sense. You will complete and submit a loan application

which includes information about both you and the development opportunity. During these early conversations you will get to understand the bank, their loan policies and general lending requirements, and you will want to assess the bank to see if it and its terms would be a fit for you.

2. **Determine loan terms** – A bank will typically have a clear set of criteria for which it establishes real estate investment loans. Like any investor, they will want a diverse portfolio of asset classes, geographies, investment types, and risk/return levels. During this stage of the process, the lender will consider where your project fits into those criteria, and then look at the current economic and lending market to calculate what terms they would likely want to issue you a loan. Whereas the terms in home mortgages are generally set, negotiating the terms of a commercial loan is common. Once the lender provides you with a term sheet or written proposal, that is your opportunity to request more favorable terms, if desired. Remember, this is a business for them too. They want to lend money for good investments; they aren't simply doing you a favor.

3. **Underwriting and approval** – In many ways, a bank's underwriting process is the equivalent of your financial analysis. They will pull together their own financial analysis, along with the other information they collected from you, to determine the risk of investing in your project. From that underwriting they will determine if your project meets their investment criteria. If so, they will finalize the loan terms and approve your loan.

4. **Due diligence** – Bank due diligence is, in many ways, the same as the due diligence you should do even if you didn't need debt financing. A bank, just like any equity investor, will want to understand the opportunity as clearly as it can and take all reasonable measures to mitigate risk. As such, a bank's due diligence will include steps like title review, survey, appraisal, and environmental studies. Be sure you are aligned with your lender during due diligence; she will order most work to be completed (at your expense) and will have certain requirements for how it is managed, such as preferred venders.

5. **Loan Closing** – Much like closing on a home loan, once due diligence is complete and the loan is approved, the bank will still require some time to pull all of its paperwork together. Typically, you will then close on the loan at the same time you close on the property.

### *C. Post-closing*

Closing on a loan is a big milestone, but does not end the relationship with your lender. Of course, critically, the borrower must make her loan payments on the schedule that she agreed. Commercial loans, however, require a bit more active management than home mortgages. To start, a commercial loan will typically have certain reporting requirements (which also can be negotiated.) For example, a loan agreement may stipulate that the borrower must submit annual or quarterly financial statements. A lender requires this information to ensure that the property is being managed sufficiently and that the financial status remains stable.

A commercial loan may also have various loan covenants that restrict what the borrower is able to do with the property or even with his business. For example, a lender may restrict a borrower from significantly altering the structure without approval, or finalizing a lease without lender approval. A lender will also want to be sure the business does not become over leveraged (take on too much debt) so it may limit additional debt on the property or business.

Finally, it is important for a borrower to manage the relationship with the lender. Just as you did during the application process, you will want to continue to demonstrate professionalism and high competency when you submit reporting requirements, seek approvals, and otherwise interact with your lender. In addition to making her job easier, it will build a strong relationship for the future. You may want to obtain another loan for a second or third project and the lender's history in working with you will be a critical factor. Additionally, demonstrating strong management and being transparent with your reporting, will help you work through any issues that may arise; your lender will be more likely to work with you to help resolve it and/or modify the loan, rather than to call the loan, tighten terms, or push the property into foreclosure.

### Applying This to You!

Start to identify who your lender partners might be. Conduct an internet search, ask other developers and brokers for recommendations, and look for posted "Financed by …" signs at construction sites. Record the results of your research in one location including names, contact information, and comments.

# V. Lending for small scale development

## A. Financing tools for small development

For small scale development, there are various options for financing that, depending on asset class, down payment, owner occupancy, and if construction is new or a renovation, should be considered. Options for residential and some commercial development that are backed by the Federal Housing Administration (FHA), Department of Veterans Affairs (VA), Fannie Mae, Freddie Mac, and the Small

Business Administration (SBA) are available to help developers more easily secure financing.

For the lowest cost end of the spectrum, for example a "fix and flip" home or for constructing an Accessory Dwelling Unit, ADU (a second, smaller residential structure on an existing residential lot) financing would likely come from personal home equity, friend and family investments, and/or hard money. Hard money are loans provided for short periods of time (e.g., 6 months.) Hard money loans can benefit developers by providing needed funds up front without interim interest payments. However, hard money interest rates are typically much higher than other forms of debt financing.


Investors buying and/or remodeling 1-4 unit residential structures have some additional loan sources available to them, primarily through the FHA. The FHA 203(b) loan can be used to finance the purchase of a primary residence of 1-4 units with a minimal down payment. Also for 1-4 unit residential properties, the FHA 203(k) loan provides funds for both acquisition and remodeling. VA loans are similar to FHA 203(b) loans but have additional benefits for veterans including reduced fees and zero down payment. For both FHA and VA loans, the home must be your primary residence; however, if there are 2, 3, or 4 units, you can live in one and rent the others out. In addition, Fannie Mae and Freddie Mac have various lending options for purchasing 1-4 unit and larger multifamily properties, depending on an investors specific situation.

For owner-occupied commercial properties, a real estate investor may want to obtain an SBA 504 loan. The 504 loan will provide debt funds of 30-40% of the cost to buy or build a building (paired with another 50% from the bank), up to a cap of usually $5 million. The borrower must use at least 51% (80% if new construction) of the building for its own operations, but it can lease out the remaining space.

To help finance mid-sized properties, investors and developers will typically seek out traditional financing through a bank that offers multifamily and commercial lending. Freddie Mac, however, does offer a Small Balance loan for residential properties with 5 or more units that are non-recourse and offer competitive terms.

## *B. Lending before value exists*

A new developer may question how she can borrow money to construct or significantly renovate a building when lenders are so focused on limiting loans to a percentage of the value of the property. Prior to construction, the property value may be fairly low. To overcome this, lenders do provide various types of construction loans that can be paired with first mortgages to allow for purchase and construction. As noted previously, the value used to calculate maximum loan amount is based on either the current value plus the projected construction cost, or on the estimated appraised value upon completion of construction. Funds for construction loans are disbursed in phases as construction progresses. Often interim construction loans are refinanced by the borrower upon completion and property stabilization in order to secure better terms. Some loans are structured as “single-closing” transactions where the construction loan automatically converts to permanent financing once construction is complete.

### *C. Starting development with a “house”*

While there are various lending options available for small scale commercial, the number of options and favorability of terms for residential property lending is even more extensive. It is for this reason that many small developers begin investing in residential properties. At the same time, it is important to understand that for a property to qualify as a residential property and be eligible for many of the favorable loans, including FHA financing and even conventional home mortgages, it does not have to be 100% residential. A mixed-use property that has up to 49% of its space as commercial can still be considered a “house” for lending purposes. This means that a three-story mixed use building with apartments on floors 2 and 3 and commercial office or retail space on the ground floor can be considered a “house.”

**Applying This to You!**

What lending programs might work best for your situation? Are there any creative ways to adjust your development plan that might enable you to qualify for more or better lending options?

When it comes to securing financing for your development it is important to remember that a lender should be your “business partner.” Both words are important. Lending is their business. They want to make loans. If they don’t, they don’t make money. But they need to be your partner too. A strong relationship with your lender builds trust and helps support your business needs during both good and bad times.

# Section 7: Design & Construction

## Key Concepts

- Design and construction can be one of the most exciting parts of real estate development but, given its complexity and cost, it is wise to fully consider what you can do on your own versus what you should hire out. Avoiding professional fees upfront may backfire if that leads to poor design, work redo, schedule delays, and missed savings opportunities.
- Good design can help make a development successful by meeting building requirements in creative ways that lower costs. Designs that are repeatable, flexible, and cost-effective can be attractive and will usually save developers on design and construction.
- Residential development over the past 70 years has left a gap of duplexes, four-plexes, rowhouses, and small apartment buildings; these designs may offer small developers a manageable investment and could help create more walkable communities.
- Construction begins at property inspection. Knowing risks and getting a preliminary estimate of costs early in the process is critical to assessing financial feasibility and determining if the investment is even worth pursuing.
- A knowledgeable and trusted general contractor can be one of a developer's most critical partners, but that begins with a solid contract. A developer should have a good understanding of how contractors are paid, different contract structures, and the key elements of a contract in order to establish a clear, solid relationship from the start.

## I. Initial considerations

### *A. Do it yourself v. Hiring expertise*

When it comes to design and construction, your decision about whether you hire out all or a portion of the work will depend on your knowledge, time, and the project complexity. Many individuals who are knowledgeable with home construction expand into owning rental properties as a natural investment. Understanding how buildings work and having the skill to build and make improvements can save a developer money and make it easier to identify opportunities. While that skill set can apply to residential properties with multiple units and even commercial properties, as a building gets more complex (e.g., elevators, HVAC units, asbestos, roof membranes) even a knowledgeable developer may want to engage design and construction partners. While the cost of this can be concerning initially, good partners will typically be worth more than their fees by managing costs, preventing mistakes, and keeping a project on schedule. Losing a few months in the development process due to having to resubmit a proposal or redoing electric work because it is not to code have a significant impact on your financial outcome. In short, you will need to determine if the cost of bringing on outside experts justify the time they save you and the risk (financial, schedule, legal, etc.) they help you avoid.

## *B. Key partners – Architect, Civil Engineer, General Contractor, and others*

The partners needed on a design and construction team can vary depending on the size and complexity of the development, in addition to a typical architect and contractor, large and/or unique projects may have environmental engineers, sound and lighting engineers, structural engineers, and maybe even a feng shui consultant. Fortunately, most smaller developments do not require so many specialists. Nonetheless, there are three key partners that are critical to design and construction that any small developer should have, especially if the developer does not have expertise in those areas.

**Architect –** An architect does more than simply layout floor plans and design an interesting building exterior. An architect must be knowledgeable in local building and zoning codes to ensure your building is designed property. A good architect will know the local entitlement process and help you navigate through approvals. An architect should creatively translate the developer's vision to reality, while managing within a given budget. Finally, the architect should be a leader in the process, pulling together other engineers and consultants to create an effective and attractive design.

**Civil Engineer –** Having a good civil engineer is important from the early stages of a project given so much of the design and construction variables have to do with the property – property survey, soil conditions, drainage, vehicle access and circulation, building positioning, parking, etc. A strong civil engineer will identify site risks early in due diligence and the cost and feasibility of overcoming them. The civil engineer can also be a valuable partner in the approval process, given that much of what is reviewed is tied to site plans and adherence to zoning.

**General Contractor** – Unless you are well versed in building construction, having a knowledgeable contractor is essential to managing costs and mitigating risk. Your "GC" should walk through any building you are considering purchasing, ideally even before a purchase agreement is signed. Your contractor should provide you with a rough, but informed estimate of construction costs to help you run your financial analysis, and regularly refine that estimate throughout the development process as new information is discovered. In addition, your general contractor should be able to coordinate the work of many sub-contractors, ensuring quality work and keeping them on schedule and budget.

### Applying This to You!

What is your level of knowledge and skill, availability, and access to tools in architecture, civil engineering, and construction? How complex is your development or redevelopment? Are there any aspects of your project that may require specialized expertise? If the project complexity exceeds your capabilities, now is the time to start getting to know potential partners.

## II. Design

### *A. Principles of good design*

Design can be one of the most exciting parts of development. It provides an opportunity to put your creative mark on your neighborhood landscape. Good design delivers an attractive and timeless building. Yet, good design must also provide a solid structure that is highly functional, or it will not endure. Often, a building can be built to be both attractive and functional – they are not necessarily mutually exclusive. However, this is not always the case. An office building with a curved exterior wall may look beautiful from the street, but it leaves inefficient floor plates for offices and workstations – not to mention it is expensive to build. This is as true for small developments as it is for multi-million dollar buildings. Fortunately, there are some proven building typologies that are the bread and butter of the small developer that deliver functionality and efficiency. These typologies include fourplex and eight-plex rectangular apartments, townhomes, and simple mixed-use retail and residential buildings. These designs continue to be used because they have simple building layouts and use local materials. Not only are these building designs typically more affordable to design and build, they also avoid many of the headaches that buildings with structured parking, elevators, etc. have. There are a few common attributes that make these typologies endure:

**Repeatable** – Even though no two sites are exactly the same, building designs with common shapes and basic elements can often be repeated with little alteration. This reduces the time and cost of design and construction.

**Flexible** – Designs that are flexible, accommodating a range of tenant needs not only can be used in multiple development situations, but are more marketable since they can support a broad range of tenants.

**Cost-Effective** – Design is not just about shape; it includes material selection as well. Choosing materials during design that are proven to be attractive and durable, yet are reasonably priced will keep overall construction costs in check.

## *B. The Missing Middle*

When it comes to housing, we are quite familiar these days with construction of single family homes and large (50+ unit) apartment buildings. However, there are numerous other styles of housing that were common prior to the end of World War II. These housing styles create higher density than single family homes but are not as dense, nor as tall as larger, multi-story apartment buildings. Dubbed "the missing middle," these styles include duplexes, triplexes and fourplexes; courtyard apartments; row houses and townhomes; and multi-plex apartments. Planners tout the benefits of the missing middle as providing more housing options for different types of households, improved density that supports walkable communities, and options to make housing more affordable. While developing housing in the missing middle is less prevalent than it was before the end of World War II, developers, city planners, and residents are starting to recognize the value. Understanding the missing middle is important for small developers, as it may offer income producing opportunities at a manageable investment level. While the missing middle is re-emerging as an option for both builders and buyers, it still has some challenges. Some communities continue to resist mid-scale residential, formally through zoning or informally by vocalizing their objections, even when it is designed to be compatible with neighboring single family homes. In addition, if land and/or labor costs are too high, it may not be financially feasible to finance and develop mid-scale housing; higher density may be necessary to make the economics work. Nonetheless, in some locations, the missing middle, built to accommodate today's needs, can be a desirable alternative for those looking for housing that supports dense, walkable communities at a human scale.

> **"Missing Middle"**
> A range of multi-unit or clustered housing types compatible in scale with single-family homes that help meet the growing demand for walkable urban living.
> *Source: Opticos Design*

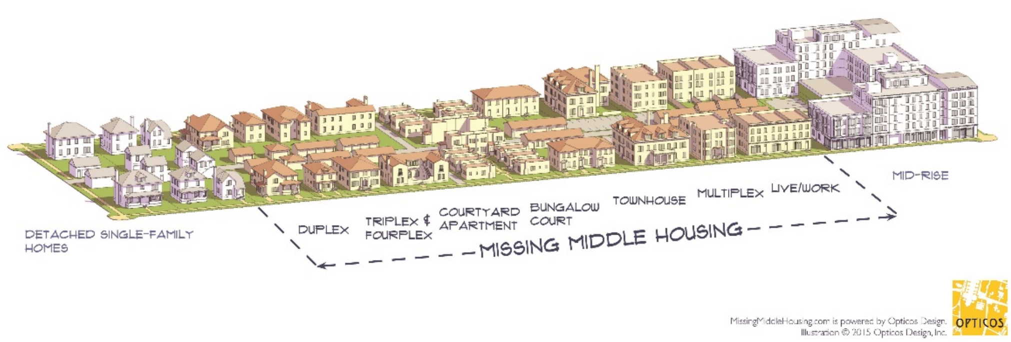
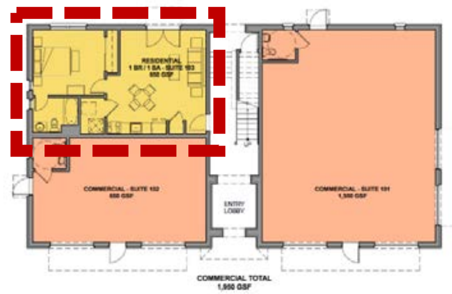


*Image courtesy of Opticos Design. Image may only be used with accompanying illustration attribution to Opticos Design, Inc.*

## *C. Accessible design*



One challenge that small developers may face is designing a cost-effective building that also is accessible to those with disabilities, fully meeting ADA, Fair Housing Act, and local code requirements. In particular, buildings with multiple floors can be challenging because the cost of an elevator is a significant investment; the small building size may not generate enough income to absorb the price of the elevator. For housing, this issue can often be resolved by building an accessible unit or units on the ground floor. For example, the building in the floor plan shown has four units on an upper level, but because it also has a fifth unit at ground level, an elevator is not necessary.

## *D. Design Process*

Understanding the main phases of the design process are helpful when engaging with your design team and determining timing and pricing. For large and complex projects there are four main phases of design. Smaller or more straightforward projects may condense the process (e.g., skip design development.)

**Schematic Design** – Preliminary drawings that show general building massing, rough locations and sizes of main areas, and exterior renderings. These drawings are intended to align architect and owner, without going into too much detail (and therefore time and cost.) Schematic drawings are also used for approvals during the entitlement process.

**Design Development (DDs)** – This phase is intended to be more detailed than schematic design, and begins to include aspects such as mechanical, electrical, and plumbing, but stops short of producing the level of detail needed for construction. Design development further aligns owner and designers and can be beneficial in identifying efficiencies and cost savings opportunities.

**Construction Drawings (CDs)** – Construction Drawings provide sufficient detail about all aspects of the building design to enable construction. CDs include both drawings and specifications, written instructions indicating systems, materials, equipment and other standards to follow. Bids and permitting can be obtained using CDs.

### Applying This to You!

Look at your design. Are there any ways to make it more repeatable, flexible, or cost-effective without losing functionality and attractiveness?

## III. Construction

Construction is often one of the most exciting parts of the development process, but it also can produce anxiety. After months, or even years, of hard work to find and purchase a property, evaluate the opportunity, design the building, and obtain approvals, you finally begin to see the physical reward for all of that effort. Nonetheless, construction can be stressful because of the amount of money now being spent and the potential for unforeseen conditions to arise that can delay the project and increase the cost. To mitigate that risk, it is important to be proficient in certain elements of the construction world, including contracts, scope of work, and budgeting, to enable strong and trusting relationships with contractors.

### *A. Evaluating a building*

When purchasing a built property (even if you plan to tear down the building) you will need to do a thorough inspection to understand if it meets your needs, if there are any concerns that may need to be corrected, and roughly what your plans for the site will cost. You may be able to conduct your own initial evaluation when first assessing the property, but you should be sure to have a detailed inspection conducted by a qualified individual prior to closing. Regardless of whether you hire your inspection out, or you feel qualified to do the inspection yourself, there are a few key elements that should especially be inspected.

- Roof – What type of roof is it (sloped, flat, etc.)? What is the condition of the roof? How steep is it and how many slope changes are there? Is there sufficient drainage?
- Insulation – Where is it located? How effective is it (R-rating)? Does it contain asbestos?
- Foundations and structure – Can it be inspected? Are there any visible cracks or other issues?
- Mechanical System – How is the building heated, by water (radiators), air (furnace), or electric (baseboard)? What are the age and efficiency of the heating units?

- Electrical Systems – What is the age of the panel? Does the panel include breakers or fuses? How old is the wiring? Are outlets grounded and have GFCI where necessary?
- Plumbing – Are the pipes copper, plastic, steel or iron? Is the water pressure and flow adequate? How old is the main line drain?
- Doors and Windows – How old are they? How do they operate? Are they sufficiently air tight? Do they all have screens?

## *B. Contracts*

If you are hiring a project manager or general contractor to manage your construction, it is helpful to understand some of the basics of construction contracts to aid in your discussions and negotiations. To start, often developers will reach out to multiple contractors (typically three or more) to get bids based on a specific scope of work. If the scope is clear enough, including detailed drawings, contractors should be able to provide a fairly accurate estimate of cost. Ideally you will have pre-qualified all contractors, and can then make your decision based on the lowest bid price – though you may select your GC based on various factors. If you have a relationship with a specific contractor or otherwise do not want to "go out to bid" you may simply seek a negotiated contract.

When negotiating a contract, there are a few important items that the owner should be sure are included in the agreement, namely:

- Scope – What work is the contractor's responsibility. The more detailed scope, the better, ideally based on construction documents and specifications. If scope is based on drawings, the date of the drawings should be referenced.
- Schedule – Project phases, start and finish dates of each phase, dates of other critical milestones, final project end date.
- Budget – How much will the contractor get paid?
- Terms of Payment – How will they be paid, how often will they send invoices, and how long does the owner have to pay the invoice?
- Insurance and Bonding – The contract should confirm they are covered, list what is covered, and the dollar amount of coverage.
- Liens – How are liens managed, both for the contractor and subcontractors?

## *C. Scope of Work*

Sometimes, when pulling together a contract, it can be tempting to disregard the importance of having a good description of the work that will performed. Having a well-crafted scope of work will greatly reduce the odds of future conflict between contractor and owner, and can save time and money. Referencing drawings in a scope of work goes a long way to clarifying exactly what work needs to be performed. Yet, even with drawings, there are still additional considerations that should be covered in the scope of work to ensure alignment between developer and contractor.

- Work performed – Detailed explanation of the work that will be performed, including a clear description of the finished state.
- Major fixed equipment – Specify who is furnishing major equipment, contractor or owner, and who is installing the equipment.
- Fixtures and finishes – Include specifications or names of hardware, fixtures, finishes to be installed or used as examples of level of quality and cost. The contract should also be clear about when and how approvals for fixtures and finishes will be obtained.
- Permits – It should be clear if the owner is responsible for obtaining permits for work or if that will be handled by the contractor.

## *D. Budgeting – Structure of quotes*

Pricing within contracts (i.e., how contractors are paid) can take many forms. Pricing must cover both the work and materials as well as the overhead and profit for the contractor. Which type of pricing structure is used will depend on many factors, including how well the project scope is defined, risk tolerance by each party, negotiating position, and project complexity.

**Lump Sum Contract** – The owner agrees to pay the contractor a fixed fee for the work. In this structure, the contractor is taking on all risk of unexpected costs; as a result, the contractor will want a higher markup to help cover unforeseen costs and their added risk.

**Unit Price Contract** – A unit price contract may be used when the quantities of certain tasks or items are not fully known. The contract specifies a price per task or per unit, but then charges the owner based on the final number of "units." Since the number of units is variable, this approach shifts some of the risk away from the contractor and on to the owner.

**Cost Plus** – In a cost plus contract the owner agrees to pay for all costs of construction (i.e., labor and materials) as well as a certain fee on top of those costs to cover contractor overhead and profit. The fee paid is typically either a percentage of the cost or a fixed fee. This approach may be desired by contractors when the scope of work has significant uncertainty. Conversely, a cost plus contract is less favorable to owners as all unforeseen costs get passed along directly to them. Further, the contractor has little incentive to seek out ways to reduce construction costs since they are paid the same, or more if the fee is a percentage, if costs rise.

**Guaranteed Maximum** – In a guaranteed maximum contract, the contractor and owner agree on a project cost plus a set fee for the contractor, but the contractor also agrees to set a maximum total cost of the project. This structure keeps some of the risk to the owner, but limits his total exposure. It also gives the contractor some incentive to carefully manage costs.

**Incentives/Fees at risk** – While less common with smaller projects, contracts sometimes incorporate incentives paid to the contractor if cost savings are achieved, the project is finished ahead of schedule, or other beneficial outcomes are achieved. These incentives may be in the form of flat bonuses or cost savings sharing. Similarly, owners may even negotiate a contract that penalizes contractors (i.e., puts their fees at risk) if certain goals are not met.

Finally, it should be noted that even with lump sum contracts or guaranteed maximums, contracts can still exceed the maximum if the owner requests a change to the original scope of the project; this is known as a change order.

## E. CSI Work Segments

The Construction Specifications Institute is an organization that maintains the standards for construction specifications. The standards, known as CSI Codes, are organized into 50 Divisions of construction information. Several of the most relevant for small scale development are listed below.

| | | | |
|---|---|---|---|
| **03** | Concrete | **13** | Special Construction |
| **04** | Masonry | **14** | Conveying Equipment |
| **05** | Metals | **21** | Fire Suppression |
| **06** | Wood, Plastics, and Composites | **22** | Plumbing |
| **07** | Thermal and Moisture Protection | **23** | Heating, Ventilating, and Air Conditioning (HVAC) |
| **08** | Openings | **26** | Electrical |
| **09** | Finishes | **27** | Communications |
| **10** | Specialties | **28** | Safety and Security |
| **11** | Equipment | **31** | Earthwork |
| **12** | Furnishings | **33** | Utilities |

### Applying This to You!

Make a list of the aspects of your property and existing structure(s) that face the greatest risk of negatively impacting your construction budget or timeline. Determine a plan for mitigating those risks. Do the same for your planned new construction.

What is the scope of work you need from a general contractor? Before speaking with potential contractors, draft your own scope of work. This will help you determine what questions to ask during interviews and aid in your review of any proposals you receive.

## Activity F: Pulling It All Together

# Zoning, Site Plan, and Financial Feasibility

## Directions

1. Read Zoning Code Reference Sheet on the following page
2. Select a lot from the list below
3. Sketch out a rough site plan and building for that lot to determine size and number of units
4. Test the project using a single year financial analysis using assumptions noted below
5. Repeat with two other lots and compare options

## Lots

| | Use | Zoning | Lot Dimensions | Purchase Price |
|---|---|---|---|---|
| A | Commercial | C1 | 48' wide by 130' deep | $350,000 |
| B | Commercial | C2 | 60' wide by 115' deep | $275,000 |
| C | Commercial | OR1 | 45' wide by 125' deep | $210,000 |
| D | Residential | R3 | 42' wide by 130' deep | $110,000 |
| E | Residential | R4 | 45' wide by 124' deep | $125,000 |
| F | Residential | R5 | 50' wide by 120' deep | $174,000 |

## Assumptions

**Revenue**

Residential: $2.00 - $2.25 per SF per year, Gross

Commercial: $11-$16 per SF per year, Net

Building Rentable SF = 85% of Building Gross SF

**Costs**

Construction Hard Costs: $125-$140 SF

Construction Soft Costs: 20% of Hard Costs

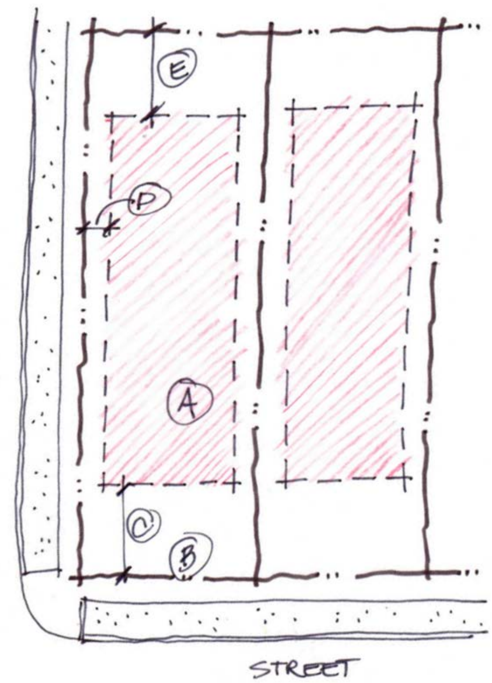
Operating Expenses & Taxes: 45% of Effective Gross Income

# Zoning Code Reference Sheet for Sample Exercise

## Purpose of Zones

The **R3 and R4 Multiple-Family Districts** are established to provide an environment of predominantly single and two-family dwellings and smaller multiple-family developments on lots with a minimum of 5,000 square feet, and at least 1,500 square feet of lot area per dwelling unit for R3 and at least 1,250 square feet of lot area per dwelling unit for R4.

The **R5 Multiple-Family District** is established to provide an environment of high density apartments, and congregate living arrangements on lots with a minimum lot area of five thousand (5,000) square feet.




The **OR1 Neighborhood Office Residence District** is established to provide a small scale mixed use environment of low to moderate density dwellings and office uses. This district may serve as a transition between neighborhood commercial centers and the surrounding residential uses.

The **C1 Neighborhood Commercial District** is established to provide a convenient shopping environment of small scale retail sales and commercial services that are compatible with adjacent residential uses.

The **C2 Neighborhood Corridor Commercial District** is established to provide commercial services that are larger in scale than allowed in the C1 District and to allow a broader range of automobile related uses.

# Zoning Code Reference Sheet for Sample Exercise

**(page 2)**

## Summary of Key Zoning Requirements

| | **Requirements** | **R3** | **R4** | **R5** | **OR1** | **C1** | **C2** |
|---|---|---|---|---|---|---|---|
| | Maximum Impervious Surface | 60% | 85% | 85% | N/A | N/A | N/A |
| | Maximum Lot Coverage | 45% | 70% | 70% | N/A | N/A | N/A |
| | Parking Spaces Required<br>Off-Street Per Dwelling Unit* | 1 (or 0) | 1 (or 0) | 1 (or 0) | 1 (or 0) | 1 (or 0) | 1 (or 0) |
| | Building Height (maximum) | 35' | 56' | 56' | 35' | 35' | 56' |
| | Building Stories (maximum) | 2.5 | 4 | 4 | 2.5 | 2.5 | 4 |
| | Lot Area Needed for Each Dwelling Unit (minimum, SF)** | 1,500 | 1,250 | N/A | N/A | N/A | N/A |
| | Floor Area Ratio (maximum) | 1.0 | 1.5 | 2.0 | 1.5 | 1.7 | 1.7 |
| | **Shown on Diagram Above** | | | | | | |
| A | Minimum Lot Area (SF) | 5,000 | 5,000 | 5,000 | 5,000 | 5,000 | 5,000 |
| B | Minimum Lot Width (ft) | 40 | 40 | 40 | 40 | 40 | 40 |
| C | Front Setback (minimum, ft) | 20 | 20 | 20 | 0 | 0 | 0 |
| D | Side Setback (minimum, ft)*** | 5+2X | 5+2X | 5+2X | 0 | 0 | 0 |
| | Corner Lot Side Setback (minimum, ft)*** | 8+2X | 8+2X | 8+2X | 0 | 0 | 0 |
| E | Rear Setback (minimum, ft) | 5+2X | 5+2X | 5+2X | 0 | 0 | 0 |

* Property within one-quarter (¼) mile of a bus transit stop half or (½) mile of a rail transit stop with midday service headways of fifteen (15) minutes or less, allowed reduction is 100% of requirement for buildings 3-50 units, and 50% of requirements 51+ units

** To Calculate Number of Units Allowed on Site, take property Lot Area sf / *table value*, Round Down Result

*** X = Number of stories above the first floor. Ex: 2 story building is 1 story above the first floor, X =1

*NOTE: The zoning requirements listed herein are examples only for purposes of this exercise. Update-to-date zoning requirements from the municipality where the development is located should be used for actual development purposes.*

# Section 8: Detailed Financial Feasibility

**Key Concepts**

- While a simple, single year financial analysis is a good way to quickly assess a real estate investment, a multi-year pro forma should be used for more complex investments to account for year to year changes in income and expenses.
- A pro forma enables an investor to analyze financial details that change over time, including rental rates, turnover vacancy, operating expenses, turnover expenses, capital improvements, construction, initial lease up, and debt service.
- While the Return on Investment and Return on Equity are still important metrics, when looking at the investment over several years the Net Present Value (NPV) and Internal Rate of Return (IRR) are effective ways to evaluate the quality of the investment.
- The structure of commercial and residential pro formas are fundamentally the same, though there are some slight variances between the two, such as how income is calculated, inclusion of operating expenses, and costs at tenant turnover.

## I. Pro Forma Structure

### *A. Overview*

In Section 5 we introduced the basic concepts of real estate financial analysis, covering effective gross income, operating costs, NOI, and cap rate among other things. We learned how in real estate, as in any business, our income must exceed our expenses to produce positive cash flow, and that cash flow should give us a high enough return on our investment to justify any level of risk we are taking. In our discussion, we focused on a stable property with a one-year timeframe. However, the reality is that real estate is quite dynamic, with both revenue and costs having the potential to fluctuate from year to year. To track financial assumptions over time and understand their impact, real estate professionals will run a multi-year financial analysis (usually over a 10-year period), commonly called a *pro forma*. In addition to giving you a better understanding of your potential investment, pro formas are a standard method of communicating financial analysis in the real estate community, especially to potential capital partners and lenders.

### *B. Additional considerations for multi-year analysis*

While the pro forma has the same inputs that are listed vertically in a simple, single year financial analysis (rental income, operating expenses, NOI, etc.), its actual inputs run horizontally across several years. This enables the analyst to account for known year to year changes and more accurately incorporate investment uncertainties. Several of the most notable variances from year to year are noted below.

**Rental Rates** – Leases typically have regular rental rate increases over the term of the lease. While some are simple (e.g., 3% annual increase), others may be more involved. With multiple tenants, each with different lease agreements, spelling out exactly what is expected will provide a more accurate income picture.

**Tenant turnover** – As leases expire, tenants may move. Vacancy for a couple of months (sometimes many months!) is common during that period. Accounting for a realistic turnover period as leases expire is important so that you do not overestimate income. Also, don't forget that operating expenses must be paid, but are not reimbursed during any time that space is vacant.


**Operating expenses** – Operating expenses usually do not increase significantly year over year, but they do typically increase with inflation. Often analysts will assume 2.5-3.0% annual increases. These inflationary, as well as potentially more significant changes, should be incorporated into your pro forma. If you do plan to invest in the property to build or improve it, remember that the assessed value, and therefore the property taxes, will jump in the year or so after completion. Finally, while operating expenses do tend to rise, they don't always. If you identify ways to operate a property more efficiently, you may want to forecast a reduction in certain operating expenses in future years, once your changes have been implemented.

**Tenant Improvements and Leasing commissions** – When a tenant vacates a space, not only is there a period of reduced income, there are costs associated with bringing in another tenant. Tenant improvements are generally necessary which could involve just a fresh coat of paint or as much as a full gut and remodel. If you or your tenant are using a broker, you will have to pay leasing commissions when a new lease is signed. Also keep in mind, that you may incur tenant improvement costs and leasing commissions, albeit usually significantly lower, when an existing tenant negotiates a lease extension.

**Capital Improvements** – Roofs need replacing, parking lots need resurfacing, and elevators need upgrading. Improvements like these don't occur every year, but when they do, the costs are massive, sometimes enough to produce a cash flow negative year. Ideally, you will be setting aside money every year in a reserve for when these costs hit, but you will want to be sure the reserve is sufficient, especially if you will incur major costs early on into your investment. Just be sure in your pro forma not to double count reserve costs and capital costs for the same repair!

**Construction** – While it is important to track potential changes in income and operating expenses, the pro forma is perhaps most valuable for laying out acquisition and construction expenses early on during a new development or even a redevelopment. These early years in a pro forma are critical to understanding if cash flow will be sufficient to make a project work, and how much urgency there is or flexibility you have before income needs to be stabilized.

**Lease up period** – A new building or one that is vacant will face a period of time without tenants, so income and operating reimbursements will be zero, and slowly ramp up as the building is filled. This has the same impact to income as noted in tenant turnover, but is more critical due to the upfront magnitude and timing.

**Debt service** – Unless you have a variable rate on your loan, your debt service should be one of the most stable costs you have. However, if it is paid off during the period of time covered in your pro forma, modeling this change is important as it is likely to be a large expense. Further, if you are taking on a short term (construction) loan upfront with the intent to refinance once a property is stabilized, a pro forma enables you to track the value of the loan upfront, the payoff a couple of years in, the value of the new loan, and the related debt service amounts for both.

## C. Ending a Pro Forma

A pro forma is a nice way to account for financial changes over a longer time-period, say 10 years, but what happens then? Changes will still occur in years 11, 12, etc. Do we just keep going? It is true that changes will occur in those out years, but analysts typically feel comfortable ending a pro forma after that point for three reasons: property stabilization, time-value of money, and use of the reversionary value.


**Property stabilization** – Much of the value of a pro forma is in the early years when major investments are being made, operations are modified, and tenancy is stabilizing. Of course, leases still terminate, inflation, still occurs, and capital investments are still required in later years. However, when looking out as far as 10 years, analysts can usually

***Outgoing Cap Rate***
Demonstrating Value Add

**Goal: Outgoing Cap Rate < Initial Cap Rate**

*You want to sell a property for more than you put into it – this is called adding value. One way to do this is to lower risk. If NOI is constant and your outgoing cap rate is lower than your initial cap rate, you successfully increased value.*

make some general assumptions about these somewhat predictable changes.

**Time-value of money** – A common principle in finance is that money is worth more today than it is tomorrow. Therefore, the income and expenses we realize in year 1 are going to impact how we value the investment much more than those in year 11. This is not to say the profit earned in year 11 is meaningless, but rather if that profit is slightly higher or slightly lower than expected, because it is "discounted," the overall impact is likely fairly small.

**Reversionary value** – Just because we feel comfortable only running our pro forma out for a certain period of time, does not mean that the property ceases to exist after that period. We sure hope we will continue to earn income in years 11, 12, etc. In order to account for this, we use a *reversionary value*. The reversionary value is the estimated value of the property at the end of the pro forma. It is determined by dividing the last year of NOI by the "outgoing cap rate;" the outgoing cap rate is estimated based on the expected amount of risk in the investment at that point. For example, if a property is generating $50,000/year in NOI and the outgoing cap rate is 8%, the reversionary value will be $625,000. (See Section 5 for more explanation of the cap rate.)

All of this assumes you hold on to the property indefinitely. However, if you plan to sell the property after a certain period of time, you should include that assumption in your pro forma. Assumptions for selling a property are similar to those in the reversionary value - the value will still be NOI/Cap Rate. Except when selling a property, you will need to account for the cost of the sale (e.g., closing costs, broker commissions) and you will want to show the payoff of the principal of any outstanding loans.

## *D. Key metrics*

In a pro forma, there are a few metrics that should be calculated to measure the quality of a real estate investment. Some of these are similar to those metrics in a simple analysis, though others, such as NPV and IRR, can be included now that you are looking at financials over a period of time.

***Adding Value***

**Keep the value you add!**

*If you plan to invest in a property to generate more revenue (or lower cost) be sure to exclude those benefits when calculating the current value (i.e., price) of the property. After all, you shouldn't pay the seller today for value (and risk) that you plan to add tomorrow!*

**ROE and ROI** – Just like in a single year analysis, the Return on Investment and Return on Equity are important metrics in analyzing a real estate investment.

However, because the cash flow (return) likely varies from year to year, the ROI and ROE will vary from year to year, sometimes fluctuating quite wildly. These annual returns are informative but not always the most helpful in determining if an investment is good. The average ROE and ROI over the pro forma period provides a more consolidated metric for assessment, but it can distort wild swings and does not place any greater value on returns earned in year 1 over those in year 10. As a result, ROI and ROE can be good for more stable investments, but developments and other investments that have more dramatic swings, benefit from calculating the NPV and IRR.

**Net Present Value (NPV)** – Net Present Value is a common financial metric used to evaluate whether, over time, an investment will result in a profit or loss. NPV is grounded in the theory that future money is discounted, or worth less than money today. NPV simply is the sum of the "discounted" cash flows from each year. The further out the cash flow is earned, the more it is discounted. The amount by which the cash flows are discounted will vary from person to person (or company to company) but are based on the return you think you could achieve by investing elsewhere. Often discount rates fall between 6-10%; and each year the rate is compounded. Calculating the NPV is the hard part, interpreting it is easy. If the NPV is positive (>0) the investment puts money in your pocket. If it is negative, you are losing money. Of course, NPV is only one factor to consider. Even if you have a positive NPV, you will still want to consider whether the NPV is large enough to justify the effort, risk, and money you are investing.

**IRR –** Internal Rate of Return (IRR) is one of the more confusing metrics in finance, but is quite powerful. Without getting into a complicated explanation, IRR is a metric that indicates the return on an investment over a period of time. Rather than a simple ratio or average, it takes into consideration how much money is invested and earned and, importantly, because of the time value of money, when those investments and earnings occur. Manually determining the IRR is difficult, but it can be easily calculated in Excel using the IRR function. You typically want an IRR that is higher than the return you would get from other investments, real estate and otherwise.

IRR and NPV are often looked at together to determine the quality of an investment. IRR indicates the percentage of the return while NPV indicates the magnitude. A high percentage return may still not be worth the effort if the magnitude is low (e.g., a 40% return on $100 is $40 – not worth it if it requires much time.) Similarly, an investment with a good NPV, but that only has a 2% IRR may not be the best investment. You are likely to find another investment with a higher IRR and even better NPV.

**Cash Flow –** One of the biggest risks in new development is running out of cash. Development requires a significant amount of money up front, but it can take a while, months or sometimes years, before that development begins to generate income. An investment with a fantastic ROI that runs out of cash in the second year is not a good investment; if you are unable to pay your bills and lose the property, you will not be around to realize that fantastic return in future years. A pro forma is an ideal way to calculate year to year (or even month to month) what your cash flow will be. If at any time you show negative cash flow, or even low cash flow, you will have to find a way to lower your cost, access additional cash to cover the deficit, or skip the investment. A pro forma is also a good way to assess your risk by running sensitivities. What if it takes 18 months rather than a year to find a tenant? What if construction costs run 10% higher. Will any of these cause you to run short on cash? If so, do you have a way to cover those costs in the short term?

### Applying This to You!

What assumptions do you now need to include for your specific development when you extend your financial analysis out 5, 7, or 10 years?

Once you have created a pro forma, look to see if there are any years where your cash flow is negative or too close for comfort. Are there any steps you can take to avoid that risk?

Be sensitive. Play with some of your main income and expense assumptions. If those don't work out as well as planned (e.g., takes twice as long to lease up as estimated) will you still be ok? Are you comfortable doing this investment if any of those scenarios could realistically occur? (This is called a sensitivity analysis.)

## II. Differences in the Residential and Commercial Pro Formas

Structurally, residential and commercial pro formas are similar. They both follow the same format of Effective Gross Income, NOI, and Cash Flow, and both look across several years. There are, however, a few ways in which residential and commercial pro formas differ, including:

- **Income detail –** Commercial pro formas will often detail revenue by each tenant since they vary by size, rates, term, etc. Residential income is typically grouped by type of unit (2 bedroom, 1 bedroom, studio, etc.) and are often calculated in a separate table to show number of units, SF, rate per SF, monthly rent, etc. Also, do not forget to include supplementary income for both asset classes, such as from parking, storage, vending, and laundry.

- **Operating Expenses –** Because residential leases are typically gross leases, tenants do not pay operating expenses separately. As a result, a residential pro forma will have zero expense reimbursements. Commercial leases are often net leases, and therefore commercial pro formas will include base rent as part of gross potential income and operating expense/CAM reimbursements after the expenses line item.
- **Leasing commissions –** Residential leases do not usually require the payment of broker commissions, but commercial leases usually will.
- **Tenant Improvement costs –** Residential units may turnover fairly regularly. For example, if the average length a tenant stays in an apartment is 3 years, one-third of units will turnover every year. You should include turnover costs (e.g., cleaning, repairs, painting, etc.) every year for a certain percentage of units, depending on your expected turnover rate. Commercial lease tenant improvement costs tied to turnover will be much more irregular due to longer lease periods, but costs will be much higher at turnover, often due to a complete renovation of the space.

Mixed use pro formas add an additional layer of complexity given that they bring together both residential and commercial asset classes with different assumptions and requirements (e.g., part of the space has operating expenses reimbursements, part of the space does not.) While you can capture these differences in a single pro forma, it may be easier to create two separate pro formas (one residential and one commercial) and then bring all the critical line items (e.g., EGI, NOI) together into a third consolidated pro forma.

# III. Sample 10 Year Pro Forma – Residential

| Operating Pro Forma | | *Acq./Rehab* YR 0 | *Occupied* YR 1 | *Stabilized* YR 2 | *Stabilized* YR 3 | *Stabilized* YR 4 | *Stabilized* YR 5 | *Stabilized* YR 6 | *Stabilized* YR 7 | *Stabilized* YR 8 | *Stabilized* YR 9 | *Stabilized* YR 10 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1 Bedroom Units (2, 725 SF each) | *1,450* | - | 28,710 | 29,571 | 30,458 | 31,372 | 32,313 | 33,283 | 34,281 | 35,310 | 36,369 | 37,460 |
| 2 Bedroom Units (6, 925 SF each) | *5,550* | - | 96,570 | 99,467 | 102,451 | 105,525 | 108,690 | 111,951 | 115,310 | 118,769 | 122,332 | 126,002 |
| Other Income - Parking | | | 3,600 | 3,600 | 3,600 | 3,600 | 3,600 | 3,600 | 3,600 | 3,600 | 3,600 | 3,600 |
| *Total RSF* | *7,000* | | | | | | | | | | | |
| **Gross potential Income** | | **-** | **128,880** | **132,638** | **136,510** | **140,497** | **144,604** | **148,834** | **153,191** | **157,679** | **162,301** | **167,062** |
| Less: Vacancy Factor | *5.0%* | - | (6,444) | (6,632) | (6,825) | (7,025) | (7,230) | (7,442) | (7,660) | (7,884) | (8,115) | (8,353) |
| **Effective Gross Income** | | **-** | **122,436** | **126,006** | **129,684** | **133,472** | **137,374** | **141,392** | **145,531** | **149,795** | **154,186** | **158,709** |
| Operating Expenses | *3.0%* | (28,088) | (37,450) | (38,574) | (39,731) | (40,923) | (42,150) | (43,415) | (44,717) | (46,059) | (47,441) | (48,864) |
| Replacement Reserves | | | (1,750) | (1,750) | (1,750) | (1,750) | (1,750) | (1,750) | (1,750) | (1,750) | (1,750) | (1,750) |
| **Total Expenses** | | **(28,088)** | **(39,200)** | **(40,324)** | **(41,481)** | **(42,673)** | **(43,900)** | **(45,165)** | **(46,467)** | **(47,809)** | **(49,191)** | **(50,614)** |
| CAM Reimbursement | | | | | *None - Residential* | | | | | | | |
| **Net Operating Income** | | **(28,088)** | **83,236** | **85,683** | **88,203** | **90,799** | **93,473** | **96,227** | **99,064** | **101,986** | **104,995** | **108,095** |
| Acquisition | | (550,000) | - | - | - | - | - | - | - | - | - | - |
| Tenant Improvements | | (175,000) | - | - | - | - | - | - | (35,000) | - | - | - |
| Leasing & Capital Costs | | (123,500) | - | - | - | - | - | - | (15,750) | - | - | - |
| **Cash Flow Before Financing** | | **(876,588)** | **83,236** | **85,683** | **88,203** | **90,799** | **93,473** | **96,227** | **48,314** | **101,986** | **104,995** | **108,095** |
| *Debt Service Coverage Ratio* | | | *1.55* | *1.59* | *1.64* | *1.69* | *1.74* | *1.79* | *1.84* | *1.90* | *1.95* | *2.01* |
| Loan Funds | | 678,800 | | | | | | | | | | |
| Debt Service | | (53,757) | (53,757) | (53,757) | (53,757) | (53,757) | (53,757) | (53,757) | (53,757) | (53,757) | (53,757) | (53,757) |
| Asset Management Fee | *2.0%* | | (2,449) | (2,520) | (2,594) | (2,669) | (2,747) | (2,828) | (2,911) | (2,996) | (3,084) | (3,174) |
| **Cash Flow After Financing** | | **(251,545)** | **27,030** | **29,405** | **31,852** | **34,373** | **36,968** | **39,642** | **(8,354)** | **45,233** | **48,154** | **51,164** |
| **Average Annual Cash Return - Before Financing** | **10.4%** | | 9.5% | 9.8% | 10.1% | 10.4% | 10.7% | 11.0% | 5.5% | 11.6% | 12.0% | 12.3% |
| **Average Annual Cash Return - After Financing** | **13.6%** | | 10.7% | 11.7% | 12.7% | 13.7% | 14.7% | 15.8% | -3.3% | 18.0% | 19.1% | 20.3% |
| | | | | | | | | | | | | *SALE - YR 10* |
| **Internal Rate of Return - 10 YEAR** | **23%** | (251,545) | 27,030 | 29,405 | 31,852 | 34,373 | 36,968 | 39,642 | (8,354) | 45,233 | 48,154 | 1,074,645 |
| **Net Present Value (NPV), 7%** | **465,429** | | | | | | | | | | | |

| **SALE** | Exit Cap Rate | | ***7.5%*** |
|---|---|---|---|
| | | | ***YEAR 10*** |
| | Estimated Value | | 1,441,268 |
| | Outstanding Loan Balance | | (388,962) |
| | Less Sales Cost | 2% | (28,825) |
| | **Sale Proceeds** | | **1,023,481** |

| **Unit Type** | **# of Units** | **SF per Unit** | **SF** | **$/SF/Month** | **Monthly Rent per Unit** |
|---|---|---|---|---|---|
| 1 Bed | 2 | 725 | 1,450 | 1.65 | 1,196 |
| 2 Bed | 6 | 925 | 5,550 | 1.45 | 1,341 |
| | | | 7,000 | | |

# IV. Sample 10 Year Pro Forma - Commercial

| | | *Acq./Rehab* | *Occupied* | *Stabilized* | *Stabilized* | *Stabilized* | *Stabilized* | *Stabilized* | *Stabilized* | *Stabilized* | *Stabilized* | *Stabilized* |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Operating Pro Forma** | | **YR 0** | **YR 1** | **YR 2** | **YR 3** | **YR 4** | **YR 5** | **YR 6** | **YR 7** | **YR 8** | **YR 9** | **YR 10** |
| Tenant 1 | *3,200* | - | 40,000 | 41,200 | 42,436 | 43,709 | 45,020 | 46,371 | 47,762 | 49,195 | 50,671 | 52,191 |
| Tenant 2 | *2,100* | - | 24,000 | 24,720 | 25,462 | 26,225 | 27,012 | 27,823 | 28,657 | 29,517 | 30,402 | 31,315 |
| Tenant 3 | *1,700* | - | 21,000 | 21,630 | 22,279 | 22,947 | 23,636 | 24,345 | 25,075 | 25,827 | 26,602 | 27,400 |
| *Total RSF* | *7,000* | | | | | | | | | | | |
| **Gross potential Income** | | **-** | **85,000** | **87,550** | **90,177** | **92,882** | **95,668** | **98,538** | **101,494** | **104,539** | **107,675** | **110,906** |
| Less: Vacancy Factor | *5.0%* | - | (4,250) | (4,378) | (4,509) | (4,644) | (4,783) | (4,927) | (5,075) | (5,227) | (5,384) | (5,545) |
| **Effective Gross Income** | | **-** | **80,750** | **83,173** | **85,668** | **88,238** | **90,885** | **93,611** | **96,420** | **99,312** | **102,292** | **105,360** |
| Operating Expenses | *3.0%* | (28,088) | (37,450) | (38,574) | (39,731) | (40,923) | (42,150) | (43,415) | (44,717) | (46,059) | (47,441) | (48,864) |
| Replacement Reserves | | | (1,750) | (1,750) | (1,750) | (1,750) | (1,750) | (1,750) | (1,750) | (1,750) | (1,750) | (1,750) |
| **Total Expenses** | | **(28,088)** | **(39,200)** | **(40,324)** | **(41,481)** | **(42,673)** | **(43,900)** | **(45,165)** | **(46,467)** | **(47,809)** | **(49,191)** | **(50,614)** |
| CAM Reimbursement | *3.0%* | | 40,747 | 41,969 | 43,228 | 44,525 | 45,861 | 47,237 | 48,654 | 50,114 | 51,617 | 53,166 |
| **Net Operating Income** | | **(28,088)** | **82,297** | **84,818** | **87,415** | **90,090** | **92,846** | **95,684** | **98,607** | **101,617** | **104,718** | **107,912** |
| Acquisition | | (550,000) | - | - | - | - | - | - | - | - | - | - |
| Tenant Improvements | | (175,000) | - | - | - | - | - | - | (35,000) | - | - | - |
| Leasing & Capital Costs | | (123,500) | - | - | - | - | - | - | (15,750) | - | - | - |
| **Cash Flow Before Financing** | | **(876,588)** | **82,297** | **84,818** | **87,415** | **90,090** | **92,846** | **95,684** | **47,857** | **101,617** | **104,718** | **107,912** |
| *Debt Service Coverage Ratio* | | | *1.53* | *1.58* | *1.63* | *1.68* | *1.73* | *1.78* | *1.83* | *1.89* | *1.95* | *2.01* |
| Loan Funds | | 678,800 | | | | | | | | | | |
| Debt Service | | (53,757) | (53,757) | (53,757) | (53,757) | (53,757) | (53,757) | (53,757) | (53,757) | (53,757) | (53,757) | (53,757) |
| Asset Management Fee | *2.0%* | | (1,615) | (1,663) | (1,713) | (1,765) | (1,818) | (1,872) | (1,928) | (1,986) | (2,046) | (2,107) |
| **Cash Flow After Financing** | | **(251,545)** | **26,925** | **29,398** | **31,945** | **34,568** | **37,271** | **40,054** | **(7,829)** | **45,874** | **48,915** | **52,048** |
| **Average Annual Cash Return - Before Financing** | **10.3%** | | 9.4% | 9.7% | 10.0% | 10.3% | 10.6% | 10.9% | 5.5% | 11.6% | 11.9% | 12.3% |
| **Average Annual Cash Return - After Financing** | **13.8%** | | 10.7% | 11.7% | 12.7% | 13.7% | 14.8% | 15.9% | -3.1% | 18.2% | 19.4% | 20.7% |
| | | | | | | | | | | | | *SALE - YR 10* |
| **Internal Rate of Return - 10 YEAR** | **23%** | (251,545) | 26,925 | 29,398 | 31,945 | 34,568 | 37,271 | 40,054 | (7,829) | 45,874 | 48,915 | 1,073,140 |
| **Net Present Value (NPV), 7%** | **466,324** | | | | | | | | | | | |

| | | | |
|---|---|---|---|
| **SALE** | Exit Cap Rate | | ***7.5%*** |
| | | | ***YEAR 10*** |
| | Estimated Value | | 1,438,830 |
| | Outstanding Loan Balance | | (388,962) |
| | Less Sales Cost | 2% | (28,777) |
| | **Sale Proceeds** | | **1,021,092** |

## Activity G: Developing a Pro Forma

**Directions** Create your own 10-year pro forma using a real estate investment that you are considering. If needed, use the table below to guide you through many of the questions and calculations that should be considered.

| | |
|---|---|
| **Acquisitions & Construction** | • What is the expected purchase price of your property?<br>• How much do you expect to spend in closing costs (e.g., financing, attorney fees, inspections, title)?<br>• What improvements do you plan to make to the property?<br>• How much do you or your contractor estimate hard costs for construction will be? Soft costs?<br>• How much construction cost contingency are you including? |
| **Income** | • What space do you have to lease? How big is each unit?<br>• For commercial spaces, are you including a pro rata share of common space into each unit?<br>• How much rent do you think each unit will generate ($/SF, $/month, $/year)?<br>• When do you anticipate that each space will start generating rent?<br>• Do you anticipate getting income from any other sources (e.g., parking, vending, billboard on building)?<br>• How much will income change year over year?<br>• What will you use as your vacancy factor? |
| **Operating Expenses** | • How much do you pay in property taxes? If you are investing in the space, how much will taxes increase when complete?<br>• How much will property insurance be?<br>• What are your costs to maintain and repair the building?<br>• What are your costs for landscaping, snow removal, and cleaning? Utilities? Security?<br>• What are your administrative expenses (e.g., property management, accounting) both internally and externally?<br>• Do you have any other operating expenses?<br>• How much will operating expenses increase every year?<br>• How much do you plan to put in replacement reserves each year?<br>• Will any of these operating expenses be reimbursed by tenants? If so, how much (don't forget to plan for vacancy)? |
| **Capital and** | • How much do you expect to have to pay brokers to help you lease out |

| | |
|---|---|
| **Leases Expenses** | your space (tenant and landlord side)?<br>• Will you have to make any tenant improvements or provide a tenant improvement allowance? If so, how much?<br>• Over the course of your pro forma, how much will you need to spend in broker commissions and tenant improvements when tenants turnover?<br>• Do you anticipate any other capital expenses over the course of the pro forma (e.g., new roof)? |
| **Financing** | • What is your total building value (or building cost) based on the acquisition price and construction?<br>• What is the maximum you expect you can borrow based on a Loan-to-Value (LTV) ratio or Loan-to-Cost (LTC) ratio?<br>• What is your Net Effective Rent (NOI = Income – Operating Expenses)? What is the maximum debt service you can pay based on your NOI and debt service coverage ratio (DSCR)?<br>• What is your interest rate, loan term, and amortization term?<br>• How much do you intend to borrow? Based on that amount and your loan terms, what will your annual debt service be? Will your LTV ratio and/or DSCR limit how much you borrow? |
| **Exit Value (or Reversion)** | • What is the NOI during the last year of your pro forma?<br>• What cap rate will you assume at exit? You can't predict the market, but you can estimate level of risk, and ideally you will have lowered the risk.<br>• Estimate the sale price during the last year (NOI/Cap Rate).<br>• What would your cost of sale be (e.g., broker commissions, closing costs)?<br>• How much principal would you still owe on your debt at the time of sale?<br>• Calculate your net proceeds from the sale. |
| **Analysis** | • What is the total cost of this investment (debt and equity)?<br>• How much equity do you need to put into this investment?<br>• What is your annual cash flow before financing? After financing?<br>• Calculate the annual and average ROI and ROE, and the NPV and IRR.<br>• Do the return metrics meet your thresholds? If not, how can it be improved? What is the maximum you can pay for the property? Is there a way to lower construction costs without sacrificing income?<br>• How does this investment compare to others you are considering?<br>• How does this investment compare to your other non-real estate investment opportunities (considering return, risk, and liquidity)?<br>• Are you being too cautious with your assumptions? Are you not being |

cautious enough?

**Key Concepts**

- Finding tenants to lease up your space can require a lot of effort, but is clearly critical to a successful project. Marketing to tenants should include digital and physical advertising, but also proactive word-of-mouth efforts through new and established relationships.
- Leases can be simple or complex, but should at least cover the key business terms, rights and obligations of both tenants and landlords, and remedies for default.
- Providing tenant improvements (actual work or via an allowance) may be beneficial to both landlords and tenants as it helps tenants get operational space at low upfront cost and work, and it provides landlords with additional investment return over the term of the lease.
- Property management can be demanding or simple, depending on how a lease is written. Residential leases typically require more active day-to-day management but the issues are often smaller, whereas commercial leases may have less frequent, but more complex demands.
- Successful property management over the long-term requires building strong relationships with tenants, and good planning with smart investments to keep the property marketable.

# Section 9: Lease Up and Property Management

## I. Lease up

### *A. Finding a tenant*

Most of what we have talked about so far has had to do with spending money – finding and acquiring a property, securing financing, and design and construction. Those expenses can only be considered an investment if they lead to income, which is where lease up activity comes in. It is never too early to start the lease up process. Indeed, as we talked about in section 2 often the best place to start is with a good tenant. If you do not have a tenant committed to your development in advance, you will want to actively start marketing your property once you have it under control (i.e., have a signed purchase agreement.) Ideally, your marketing will cover three means of communication – digital, physical, and word of mouth.

**Digital** - Your digital marketing will include listing your property on lease listing sites such as LoopNet, CoStar, and MNCar's Xceligent. It may also include free sites like Craig's List, posting on your own website, and communicating via social media.

**Physical** – Physical marketing primarily includes signage and brochures, including a "for lease" sign onsite. If you are developing or redeveloping your property, having renderings of what the property will look like after completion is critical to helping prospective tenants visualize the end product.

**Word of mouth** – Digital and physical marketing, by and large, is a passive form of marketing. You put your product out there and wait for a response. The most successful marketing efforts typically come from combining passive forms with word of mouth, or relationship based marketing. This can be extremely active and time consuming, but the payoff can be huge. Word of mouth marketing includes knocking on doors and making phone calls to business owners and their representatives who might be good candidates for your space. This approach also enables you to get feedback from others in the market about what tenants are seeking, strengths and limitations with your property, and general market information.

As with other steps in the development process, you may choose to find a tenant on your own, or you may seek assistance from a real estate leasing agent. Sometimes, especially with smaller developments, the cost of paying a real estate agent may feel like a significant financial burden. However, if having a strong broker enables you to fill your space sooner and negotiate better terms, it can be worth the cost. A good leasing agent will have a strong network of tenant representatives and prospective tenants and should actively promote your property. She should know what is happening in the market on both the landlord and tenant side and may also have access to various digital listing services that you may not.

### Applying This to You!

Make a list of your target tenants. Which tenants do you think would be most interested in your space? What do you think are the best ways to reach them and get them to consider your property?

## *B. Basic lease terms*

Once you have found a tenant and agreed upon the basic business terms of a lease (as documented in a term sheet or letter of intent) the agreement should be made official by drafting and executing a lease agreement. Leases can be as simple as a page or two or can be extremely detailed and complicated. Residential leases tend to be simpler (tenants do not want to hire a lawyer to help them sign a lease) and often are a standard template that does not involve much or any negotiation on terms. Various residential lease templates can be downloaded online. Commercial leases, on the other hand, are typically more involved because the lease duration is often longer, the terms can be more complex, and the deal points are negotiated.

Regardless of whether a lease is residential or commercial, the following elements are typically included in a lease:

**Basic Terms** – This includes the business terms agreed upon between the landlord and tenant, including:

Parties – Who the lease agreement is between, defining Landlord and Tenant, and providing contact information for all parties

Space – Location of the property and the premises, in addition to any related space rights like common space and parking

Dates – When the lease starts and ends, when the tenant can access the space, when the tenant must pay rent (Note: these are not always the same)

Costs – Rental rates, including base plus any additional costs to be paid by the tenant for operating expenses, property taxes, insurance, property management, utilities, etc. This section should clearly spell out exactly what the rent will be throughout the entire lease.

Use – What the property can and cannot be used for

**Obligations of the Landlord** – The lease should clearly articulate what the landlord is doing for and providing to the tenant. These obligations include ensuring the tenant has access to and can use the premises as intended, and keeping the property clean, in good repair, and well maintained.

**Rights of the Landlord** – This includes rights such as how and when a landlord can access the premises.

**Obligations of the Tenant** – The lease should also clearly articulate what the tenant must do during the lease, which includes paying rent on time, agreed upon upkeep and maintenance, maintaining liability insurance, how to leave the premises upon lease expiration, not disturbing other tenants, and agreements to work with the landlord in special circumstances (e.g., when a landlord is refinancing the property.) Tenant obligations would also include following any property rules such as not having pets, not parking commercial vehicles in the parking lot, etc.

**Rights of the Tenant** – In addition to the right to the premises as outlined in the basic terms, other tenant rights may include any renewal options, rights to sublease, and rights to modify the space (usually after getting landlord approval.)

**Default and Remedies** – Leases will often have a section to describe what each party can do to remedy if the other party does not uphold its obligations under the lease.

This could include notice, late fees, using security deposit funds, termination of lease, filing a lawsuit, etc.

**Miscellaneous provisions** – These provisions include indemnifications (protecting each other from harm or loss), what happens if the property is taken under eminent domain or is destroyed, etc.

## C. Tenant improvements

One of the important terms that will likely be negotiated with a tenant is how the premises will be built out to serve the tenant's needs. Like so many things in a commercial lease, how tenant improvements are handled can vary widely. Some landlords will do nothing, while other landlords will build out the entire space to the exact specifications of the tenant. In addition, there are actually two ways to define what we mean when we say "who provides the tenant improvements." The first is who is paying for them and the second is who is doing or contracting to do the work. A tenant and landlord may agree to split costs (e.g., landlord builds the walls; tenant paints and installs carpet) but then agree to use a single contractor for simplicity, efficiency, and cost savings. Some tenants may want to manage the build out of the space themselves, but negotiate to have the landlord pay for a portion of the space. In this case, the landlord agrees to provide a Tenant Improvement Allowance (TIA) for a certain dollar amount that the tenant can use in the space.


How tenant improvements are structured can vary wildly, but there is some logic behind most situations. Smaller tenants who are not frequently involved in building out leased locations will often look to the landlord to lead the work. These tenants may not have the knowledge, construction partners, nor buying power of a landlord. Tenants who have multiple locations, such as regional or national retailers, may want to control their build out as they want to be sure it is built to their specifications and by their trusted partners. This is especially the case for retailers who consider their space to be a reflection of their brand.

Tenants may be reluctant to pay for the build out of their space since it requires a significant amount of money up front and is not something they can use once they vacate the space. Landlords, however, by paying for a tenant's improvements upfront and then charging the tenant more in rent are able to create a second source of income for themselves – effectively the landlord is financing the build out and (ideally) getting a good return on that "loan." Because many tenants need or want the landlord to finance the build out upfront, a landlord that is "cash poor" and unable to do so, will limit his pool of prospective tenants. This is especially important to consider if the landlord is hoping to bring in a tenant that has a high build out cost, such as a restaurant. Of course, with any “loan” there is the risk that the lender will default – a landlord could build out the space for a 5-year lease term and if the tenant breaks the lease after one year, the landlord will face a loss.

Residential leases do not typically deal with tenant improvements as it is generally expected that the tenant is moving into a space that is built-out as livable space and the tenant is accepting it in as-is condition.

# II. Property Management

## A. Tenants are customers

Sometimes, especially during lease negotiations, it can be easy to forget that as a landlord the tenant is your customer. Remember, real estate is a business and the product you are selling is space. For any business to succeed over the long-term, it needs to have satisfied customers that want to keep coming back. Even though a tenant signs a lease, this does not mean that they are locked in and you can negate your responsibilities as a landlord. Eventually, that lease will end and they will again have to decide whether to buy your product or go to a competitor. Further, during the lease they will communicate to others about their experience with you as a landlord. Having a strong brand and a good reputation is important. Providing good customer service does not mean you can’t be a strong negotiator in lease discussions nor does it mean you should short-change yourself. It does mean respecting your tenants and fully providing the product and service that you agreed to in the lease – and, in some cases, going a bit further.

## B. Property Management - Do it yourself or Hire it out

Once a property is financed, acquired, built, and fully leased out, it is considered to be stabilized. The owner can just sit back and let the lease payments roll in. Or not. Unless a lease is a triple-net or an absolute net lease where the tenant is responsible for everything, the landlord will still have ongoing property management responsibilities. These responsibilities will vary based on the terms of the lease, but very often will include things such as landscaping, snow removal, cleaning, maintaining and repairing common space, maintaining and repairing occupied space, collecting rent and tracking down missing payments, obtaining and reporting financial information, accounting, dealing with tenant issues, negotiating lease extensions and modifications, and filling vacated spaces. For smaller properties with

**Management Fee**

*Commercial leases commonly allow for a property management fee as part of operating expenses to be reimbursed by the tenant. Even if you are self-managing, it is reasonable to charge a fair market cost to your tenant for that management.*

only a single or few tenants, you may find that the property management, and even the work itself (e.g., cleaning, landscaping, repairs, etc.), can be performed by you directly. However, if you do not have the time and/or the capability to manage the property yourself you may want to consider hiring this out. This is particularly important with larger properties and as you add more properties to your portfolio. You may eventually find that it is worth it to pay someone to manage the day-to-day activities so that you can spend time on other activities that provide greater value-add, such as your next investment!

Finally, keep in mind that operations shouldn't be an afterthought. When you are doing site selection, be sure to put on your property management hat (or solicit input from your property manager) and consider the implications of that property during operations. Does the property have a lot of landscaping that will need maintaining? Do you have public sidewalks or drives that will need to be cleared promptly after every snowfall? Are there a lot of common spaces that will need cleaning?

## *C. Residential v. Commercial*

While property management of residential and commercial properties both require similar responsibilities – landscaping, repairs, accounting, etc. – the nature of the work does vary considerably. Residential leases generally are shorter term and therefore tenants in the space tend to turnover more frequently than at commercial spaces. Mid to large size apartment buildings may constantly have an apartment available for lease. Residential landlords are generally expected to maintain the building, grounds, and common areas, as well as do repairs inside the apartments such as changing lightbulbs and fixing leaking toilets. These small, but more frequent needs can be time consuming. Still some landlords do manage through this, however, by having an agreement with a tenant to mow the lawn or shovel the walk-in return for a small rent reduction.

Commercial leases are often 3, 5, 7 years or longer and therefore tenant turnover is not as great as with residential. However, when a commercial space does become vacant, the work involved to find a replacement tenant, negotiate a lease, and potentially build out new space can require numerous hours over several months. Also, commercial leases vary more than residential leases in structure. Some commercial leases stipulate that the tenant will take full responsibility for cleaning, maintenance, repairs, etc. In those cases, the day to day management of a commercial lease can be minimal. Alternatively, when landlords take on much of the operational responsibility, which is more often the case in multitenant properties, the workload can be substantial. Commercial property managers may have fewer calls for clogged toilets, but when they do get called, the scope and complexity of the project is frequently more significant than with residential requests.

### Applying This to You!

Make a list of the property management responsibilities required to maintain your property. For each of these, write down if you have the capability and desire to perform this work. Keep in mind your flexibility and accessibility to respond emergencies. Also, consider if performing this work is the best use of your time.

## *D. Ongoing investments*

Even when properties are stable, operations are being managed, and rent is being paid, an owner should not become complacent. With time, all properties need special attention. Major repairs and upgrades such as roofs, elevators, and parking lots require a lot of planning, coordination, and cash. At the least, a property owner should estimate when major future work will be needed and plan for covering that cost.

Some investments in your property may not be necessary to maintain the infrastructure and functionality, but may be important to maintain a level of quality and image, and therefore income. Properties that become dated (e.g., that aqua and mauve wallpaper in the lobby) will not command rents that they once did. Some of these fixes are easy and affordable, such as replacing wall paper. Others, such as floor layouts and the amount of natural light, can be expensive or unrealistic. Nonetheless, it is important to stay attuned to market trends, competition, and changing tenant needs, and respond appropriately to keep your property desirable and marketable.

## *E. Conclusion*

Investing in real estate can be an exceedingly rewarding experience. The people you meet, challenges you solve, community impact you have, and the income you earn makes being a real estate developer highly attractive. Not all investors must be full-time, professional real estate developers. Many opportunities exist in every community to develop or redevelop small commercial and residential properties – and the outcome can be just as fulfilling as with big developments. Success comes, not by being an expert across all aspects of the development cycle, but by having a vision and passion, being eager to learn, taking informed risks, and building relationships with strong partners to bring a complex, but exciting project together. Good luck!

# Glossary – Pro Forma Terms

| TERM | DEFINITION |
|---|---|
| Amortization | The gradual paying off of a debt by periodic installments. |
| Amortization Term | The period of time required to pay off an entire loan amount with periodic installments at a specific rate. |
| Asset Management Fee | The cost to an external party to manage the property including maintenance, repairs, leasing, capital upkeep, etc. |
| Average Annual Cash Return – After Financing | Yearly return on an investment of cash (equity) after accounting for debt service payments, calculated by dividing Cash Flow After Financing for the year by the total equity invested in the property. |
| Average Annual Cash Return – Before Financing | Yearly return on an investment ignoring whether the investment made included any debt, calculated by dividing Project Cash Flow for the year by the total investment cost. |
| Cash Flow After Financing | Money available from income after all expenses are paid except income taxes. Project Cash Flow plus borrowed cash but less debt service payments. |
| Contingency | An amount of money budgeted for unexpected or higher than expected construction costs. |
| Debt Coverage Ratio (DCR) | A ratio calculated by dividing NOI by Debt Service. This ratio is used by lenders to ensure a property owner should have more than enough income to cover their regular debt payments. Most lenders require a DCR of 1.20 to 1.25, meaning their NOI must be at least 20-25% more than their debt payments. (also known as Debt Service Ratio or Debt Service Coverage Ratio.) |
| Debt Service | Regular payments, typically both principal and interest, paid on a loan. |
| Debt Serviceable Loan Amount | The maximum amount an investor can borrow based on a given Debt Coverage Ratio and the Income Available for Debt Service (= Income Available for Debt Service x DCR.) |
| Effective Gross Income | Total income calculated as Gross Potential Income less Vacancy Expense. |
| Efficiency Factor | A ratio indicating the percentage of space in the building is actually leasable, calculated as Leasable SF divided by Gross SF. This is typically used in residential buildings, where common space is not included in leased SF calculations. |
| Exit Cap Rate (Sale Cap Rate) | Cap Rate (Capitalization Rate) is the rate of return used to derive the capital value of an income stream, calculated as NOI divided by Value. A higher cap rate is typically associated with a property with higher risk and/or lower demand, which translates into a lower property value.<br><br>Exit Cap Rate is the rate of return expected for a property upon sale or in the last year of a pro forma. NOI at exit is divided by the Exit Cap Rate to calculate the value of a property in that year (upon sale.) The goal of investment is to have a lower Exit Cap Rate than an Initial Cap Rate or Return on Cost. (A property should be more stabilized at exit than at startup and therefore should have a lower cap rate and thus be |

| | |
|---|---|
| | worth more.) |
| Expense Growth Rate | The estimated value that expense will increase each year. |
| Gross Potential Income | Total annual income that could be earned from a property if it is 100% occupied, including income from rent and other income including parking fees, laundry, etc. |
| Gross Square Feet (GSF) | Measurement of the size of the building from outside the exterior walls. |
| Hard Costs | Direct costs of construction including labor and materials |
| Income Growth Rate | The estimated value that income will increase each year. |
| Internal Rate of Return (IRR) | One indication of the value of an investment. The true annual rate of earnings on an investment. The percentage rate earned on each dollar invested for each period it is invested. IRR is also the discount rate that makes the Net Present Value (NPV) equal to zero. |
| Leasable Square Feet | Total space in the building that can be leased. Typically used in residential buildings where stairs, elevators, and common areas are excluded. |
| Loan to Cost (LTC) | Also known as the Loan to Value (LTV), the ratio of the amount of debt (borrowed money) to the cost (or value) of the property. This ratio is used by lenders to determine the amount of risk it has in lending money; often lenders will require a certain (maximum) LTC. |
| Mortgage Constant | The percentage ratio between the annual debt service and the loan principal. The Mortgage Constant is also equal to the sum of the interest rate and the principal amortization rate. The Mortgage Constant can be used to calculate the annual debt service by multiplying the Mortgage Constant by the initial Loan Principal. |
| Mortgage Insurance Premium (MIP) | The fee paid by a borrower to obtain mortgage insurance on a loan. Mortgage insurance helps protect the lender from borrower default, and is often required by lenders and/or government mortgage insurers (e.g., FHA.) MIP can be paid either as a lump sum payment at closing or in periodic payments. |
| Net Operating Income (NOI) | Income from a property after operating expenses have been deducted, but before deducting income taxes and financing expenses, calculated as Effective Gross Income – Operating Expenses + Income for Reimbursed Operating Expenses. |
| Operating Expenses | The costs of operating a property. These may include real estate tax, property insurance, regular maintenance and repairs, utilities not paid directly by tenants, and administrative and property management fees. Commercial operating expenses are typically directly reimbursed by tenants on a pro rata basis (net lease), while residential tenants do not usually directly pay for operating expenses (though the cost should be rolled into their rent as gross rent) |
| Outstanding Loan Balance | The total amount of principal still owed by a borrower at a given point in time. |
| Parking Ratio | Number of parking stalls per unit. |
| Principal Amortization Rate | The percentage at which the principal is paid off over the amortization term |

| | |
|---|---|
| Project Cash Flow | Money available from income (Rental Income, Reimbursed Expenses, Other Income) after all expenses (Operating Expenses, Vacancy, Reserves, Leasing, and Capital) are paid except financing and income taxes. |
| Rentable Square Feet (RSF) | Total space in the building that can be leased by commercial tenants which includes the space directly usable to tenants along with common area space which is leased to tenants on a proportional basis. |
| Replacement Reserves | Money set aside on a regular basis for larger, irregular expenses that are not included in annual upkeep costs. These include repairs such as roof replacement, parking lot paving, etc. Lenders will often require a minimum Replacement Reserve. |
| RU Factor | Rentable to Usable Factor, a ratio which indicates the percentage of space that a tenant rents that is not exclusively available to them, calculated as the (Rentable SF - Usable SF)/Usable SF. The difference is due to common area space such as lobbies, corridors, and bathrooms, of which each tenant pays a proportionate share. |
| SAC/WAC | Sewer Availability Charge and Water Availability Charge. Fees charged by the Met Council and Minneapolis/St. Paul metropolitan area cities for new connections to water and sewer systems. |
| Sales Cost at Disposition | The cost to sell the property, including broker commissions and other disposition fees. |
| Soft Costs | Indirect costs of construction, including design, financing, legal, and other related pre and post construction expenses. |
| Sources | A breakdown of all sources of funding for the project including all sources of equity and all loans. Sources should balance out with Uses. |
| Stabilized | A property that is fully leased to its maximum projected level. |
| Tenant Improvement Allowance (TIA) | An amount of money the landlord offers to the tenant to build out the tenant's space. |
| Tenant Improvements (TI) | Improvements to a leased space for a tenant's use. TI can include walls, ceiling, lights, restrooms, carpet, and may even include Furniture, Fixtures, and Equipment (FFE.) |
| Uses | A breakdown of how all cash that goes into a project will be used including property acquisition, construction (hard and soft costs), financing costs, fees, and carrying costs. Uses should balance out with Sources. |
| Vacancy Expense | An offset to Gross Potential Income based on the assumption of a certain level of vacancy in a building. Vacancy expense is calculated by multiplying a Vacancy Factor (often 5-15%) by Gross Potential Income based on current market conditions. |
| Vacancy Factor | An assumed percentage of the rentable space that will be vacant over the course of the year. Vacancy of this nature will typically result from market conditions and/or tenant turnover. The Vacancy Factor is used to calculate an estimated Vacancy Expense, an amount of rental income that will be lost due to expected vacancy. Vacancy factor is often 5-15%. |

# Answers to Select Activities

## Activity C

*Answers valid as of February 2017*

1 Value: $3,241,500; Tax: $61,104.26 (2015 assessed/2016 payable)
2 22-028-24-12-0002
3 YHD Foods Inc
4 112,335 SF
5 Sold 6/2003 for $70,000
6 68.2%
7 $ 1,025
8 2009=$605,000; 2013=$1,135,000
9 I2 (Medium Industrial) with SH and UA overlay districts
10 Will depend on time search is done
11 No, zoning is C1, but car washes are only (cond.) allowed in C2+
12 $ 30,209
13 Will depend on time search is done
14 Total = 17,636 AADT (2015)
15 Decrease, from 17,387 AADT in 2012 to 15,422 in 2016
16 5,400 AADT
17 Will depend on time search is done
18 Jim Voll
19 Will depend on time search is done
20 Will depend on time search is done

## Activity D

| | | |
|---|---|---|
| **Property** | 1801 Dupont Ave N, Minneapolis<br>*NW corner of 18th Avenue N & Dupont Avenue* | |
| **Planned Use** | Multi-Family Apartment building | |
| | **Calculated Value** | **Requirement/Source** |
| **Zoning Classification** | R4 | City of Minneapolis website |
| **Lot size** | 0.78 acres | Hennepin County Property website |
| **Lot dimensions** | 220 x 154.9 | Hennepin County Property website |
| **Minimum Lot Area** | 5,000 SF or 1,250 SF per unit, whichever is greater | City of Minneapolis Code of Ordinances - Title 20 Zoning Code, Section 546.530 |
| **Minimum Lot Width** | 40 feet | Section 546.530 |
| **Height Limits** | 4 stores, not to exceed 56 ft | Section 546.530 |
| **FAR** | 1.5 | Section 546.530 |
| **Yard Requirements** | Front = 15<br>Rear = 5+2X<br>Interior Side = 5+2X<br>Corner Side = 8+2X<br>X = # stories above 1st floor | Section 546.510 |
| **Maximum Lot Coverage** | 70% | Section 546.140 |
| **Impervious Surface Coverage** | 85% | Section 546.150 |
| **Parking (Min, Max)** | Min: 1 per DU<br>Max: No requirement<br>Bonus:+20% FAR and +20% max DUs (if DUs limited by minimum lot area) if all parking w/in bldg. below grade or in 2+ level parking structure | Section 541.170 and 546.130 |

| | | |
|---|---|---|
| **Property** | 1626 Lake St E, Minneapolis<br>*NW corner of Lake Street E & 17th Avenue S* | |
| **Planned Use** | General retail Sales and Services | |
| | **Calculated Value** | **Requirement/Source** |
| **Zoning Classification** | C1 | City of Minneapolis website |
| **Lot size** | 0.18 acres | Hennepin County Property website |
| **Lot dimensions** | 64.4 x 113.5 | Hennepin County Property website |
| **Minimum Lot Area** | None | City of Minneapolis Code of Ordinances - Title 20 Zoning Code, Section 548.120 and 548.220 |
| **Minimum Lot Width** | None | Section 548.120 and 548.220 |
| **Height Limits** | 2.5 stories or 35 feet, whichever is less, + Density bonus | Section 548.230 |
| **FAR** | 1.7, + Density bonus<br>Also, 5,000 SF max floor area + bonuses | Section 548.230 and 548.240 |
| **Yard Requirements** | None | Section 548.140 |
| **Maximum Lot Coverage** | None | None found |
| **Impervious Surface Coverage** | None | None found |
| **Parking (Min, Max)** | Retail: Min=4 or 1 per 500 SF gross floor area in excess of 4,000 GFA, whichever is greater; Max= 1 per 200 SF of GFA<br>Residential: Min=None, because within 1/4 mile from bus stop (otherwise would be 1 per DU); Max=None | Section 541.110, 541.170, and 541.200 |

**Max Gross SF** will depend on whether density bonuses are included.

# Activity E

| | A | B | C |
|---|---|---|---|
| | | 3 floors, 2 stable, | |
| | **Empty, fix & fill** | **fix up 1st 2300** | **Stable property** |
| SF | 4,000 | 4,200 | 2,600 |
| Rent per SF | 14.50 | 13.00 | 13.50 |
| SF | | 2,300 | 2,600 |
| Rent per SF | | 16.00 | 11.50 |
| **Gross Potential Income** | **58,000** | **91,400** | **65,000** |
| Vacancy | (2,900) | (4,570) | (3,250) |
| **Effective Gross Income** | **55,100** | **86,830** | **61,750** |
| | | | |
| | 45% | 29% | 22% |
| *Opex $/sf* | 3.75 | 3.50 | 2.75 |
| *Tax $/sf* | 2.75 | 2.75 | 2.75 |
| Opex | (15,000) | (14,700) | (7,150) |
| Tax | (11,000) | (11,550) | (7,150) |
| Opex, Tax, etc | (26,000) | (26,250) | (14,300) |
| Reimbursed Exp | 24,700 | 24,938 | 13,585 |
| **NOI** | **53,800** | **85,518** | **61,035** |
| *Cap Rate* | *13.5%* | *14.3%* | *8.1%* |
| | | | |
| Capital & Leasing Costs | - | - | - |
| **Cash Flow BF** | **53,800** | **85,518** | **61,035** |
| | | | |
| Debt Service | (30,490) | (37,142) | (41,577) |
| **Cash Flow AF** | **23,310** | **48,375** | **19,458** |
| | | | |
| **Purchase and Construction** | | | |
| Acquisition Cost | 400,000 | 600,000 | 750,000 |
| Capital (Construction) Investment | 150,000 | 70,000 | - |
| | | | |
| **Debt Calculations** | | | |
| Value (Acquisition + Construction) | 550,000 | 670,000 | 750,000 |
| LTV | 70% | 70% | 70% |
| Debt | 385,000 | 469,000 | 525,000 |
| Rate (yr) | 5.00% | 5.00% | 5.00% |
| Amort (yrs) | 20 | 20 | 20 |
| | | | |
| **Investment** | | | |
| Total Investment | 550,000 | 670,000 | 750,000 |
| Total Equity Investment | 165,000 | 201,000 | 225,000 |
| | | | |
| **ROI** | **9.8%** | **12.8%** | **8.1%** |
| **ROE** | **14.1%** | **24.1%** | **8.6%** |

**Best Investment:** The answer to the best investment will depend on each individual's investment criteria. Purely based on ROI and ROE, they rank B, A, C from best to worst. However, since C is stable, therefore less risky, and requires less work to fix and lease it, some investors may prefer an 8.1% return of C over the higher returns of A and B. B is generally a better investment than A. The ROI and ROE are stronger, and it also requires less risk and work.

# Notes

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